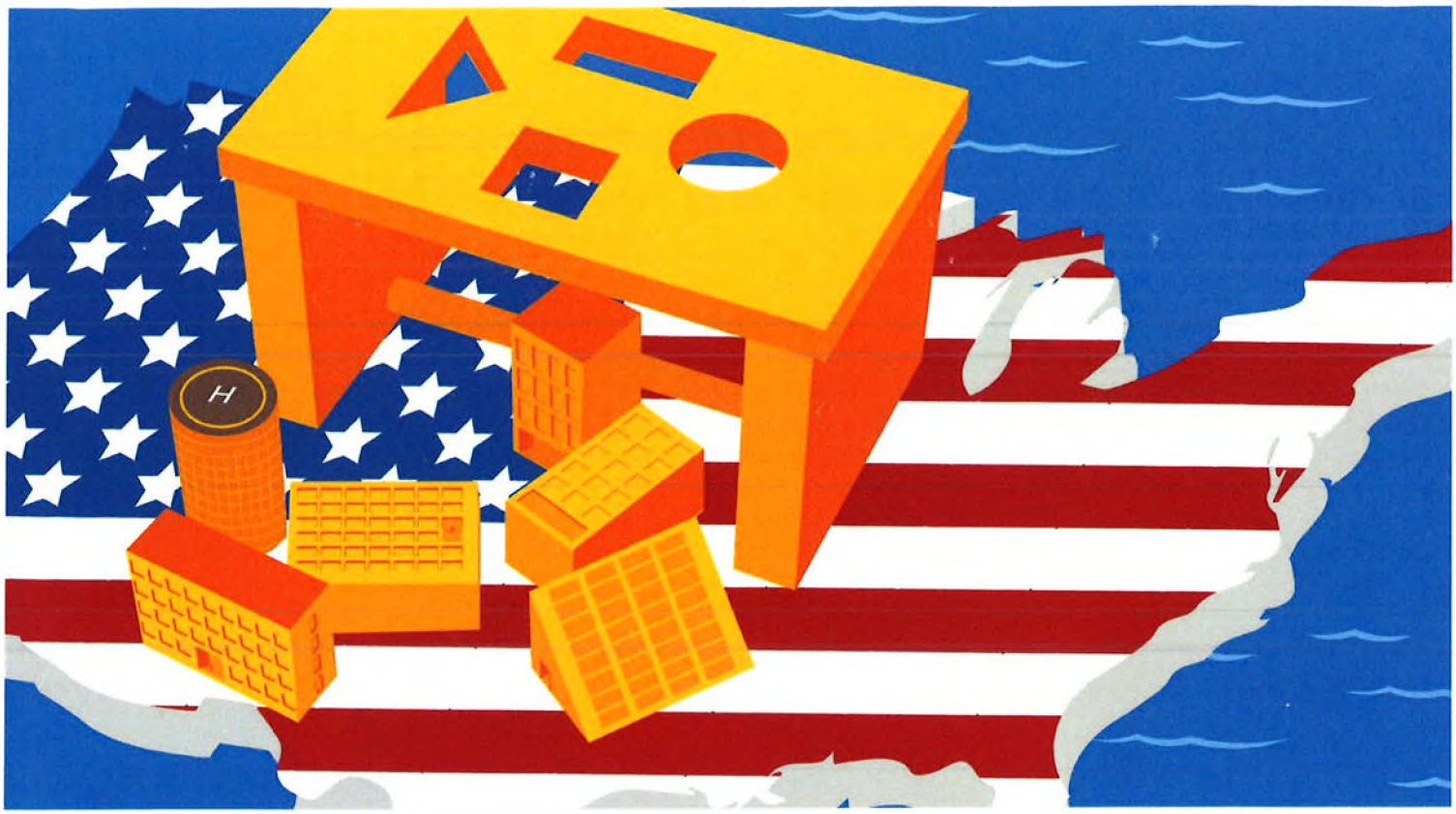

# US PRIVATE PLACEMENTS
## WHEN RULE 144A IS UNAVAILABLE

**Peter Castellon of Proskauer Rose (UK) LLP and Sebastian Sperber of Cleary Gottlieb Steen & Hamilton LLP examine a private placement exemption from US securities registration requirements that is available to non-US issuers that are offering shares to US investors.**

As a general principle of US securities law, all offerings of securities must be registered with the US Securities and Exchange Commission (SEC) or structured to satisfy an exemption from the registration requirements of the US Securities Act of 1933, as amended (Securities Act). Most offerings by non-US companies are structured under exemptions (*see box "Exemptions"*).

Typically, the portion of the offering that takes place outside the US is structured under Regulation S of the Securities Act (Regulation S), and another exemption is used to structure the US portion.

While Rule 144A of the Securities Act (Rule 144A) is the most common exemption used for the US portion in these types of offerings, it is not always available.

Section 4(a)(2) to QIBs is another exemptive route to consider for the US portion. As under Rule 144A, the US portion of the offering is limited to qualified institutional buyers (QIBs) and, as discussed further in this article, there are other similarities to Rule 144A. "Section 4(a)(2) to QIBs" does not exist as a separate statutory exemption, but a practice has developed under which securities of non-US companies are sold to QIBs under Section 4(a)(2) of the Securities Act (Section 4(a)(2)) without imposing some of the procedural restrictions that are used in many US domestic Section 4(a)(2) transactions (*see box "The Section 4(a)(2) exemption"*).

This article focuses primarily on sales to QIBs by the issuer. If Rule 144A is unavailable but the transaction is still structured as a resale to QIBs by a manager, the resale by the manager is, in fact, commonly referred to as a "Section 4(1½)" transaction. Section 4(1½) of the Securities Act (Section 4(1½)) is the interpretive doctrine applicable to resales from one buyer in a private offering to another. As a technical matter, a resale by a financial intermediary in this context is made under Section 4(a)(3), since the financial intermediary is a dealer not acting in the capacity of an underwriter, or participating in a distribution within the meaning of the Securities Act. The private nature of the transaction avoids it being deemed a distribution. Nevertheless, the procedures for conducting Section 4(1½) transactions will be comparable in many instances, especially where the issuer is not listed in the US, to those applicable to direct sales to QIBs by the issuer under Section 4(a)(2) in the contexts described in this article.

This article examines the main uses of Section 4(a)(2) to QIBs for non-US companies. The approach to Section 4(a)(2) outlined in this article is only for transactions directed in the US to QIBs (typically in connection with a concurrent offering outside the US under Regulation S). There are four common transaction scenarios when Section 4(a)(2) to QIBs may be used:

- In equity offerings, as an alternative to Rule 144A when Rule 144A is not considered to be available.
- In equity or debt offerings, where the managers are not obtaining a disclosure letter under Rule 10b-5 of the US Securities Exchange Act of 1934 (Rule 10b-5).
- In rights offerings by non-US companies.
- In mergers and acquisitions (M&A) where local law allows for differential treatment of target shareholders.

In all cases, securities sold under Section 4(a)(2) are restricted. For one year (or, in limited circumstances where the issuer is an SEC reporting company, for six months), the securities can only be sold in the US to other QIBs or in other private transactions; however, the securities can be sold outside the US at any time under Regulation S.

## ALTERNATIVE TO RULE 144A

Section 4(a)(2) can be used for primary offerings of equity securities to QIBs when Rule 144A is not available. Rule 144A could be unavailable because the securities were fungible, when issued, with securities listed on a US exchange, which is a condition of relying on the rule (*Rule 144A(d)(3)*). In the context of secondary offerings of equity securities to QIBs where the issuer of the securities is not involved, Rule 144A could be unavailable because the information furnishing requirement of Rule 144A is not satisfied.

Another common scenario is where Rule 144A is not considered to be available because the intermediaries are not buying and reselling the securities. Rule 144A, by its terms, is an exemption for resales. In order to comply with the exemption, either the seller must be a shareholder (although a subsidiary company would not be eligible to rely on Rule 144A) or, in a primary offering where the seller is the issuer, the manager must buy the shares and resell them to investors.

In some non-US jurisdictions, primary offerings are structured in such a way that the financial intermediary does not buy and resell. This can be driven by local tax or corporate law concerns, or it may be local market practice. The UK is one jurisdiction where the local practice is for agreements in London-listed initial public offerings (and other securities offerings) to be structured in such a way that the managers do not buy and resell.

Some market participants address in another way the absence of a resale of all the shares being offered. If the offering is not a resale by underwriters but is an offering of a mix of secondary and primary shares, and there is a sufficient number of secondary shares to cover US demand and the secondary shares can be segregated from the primary shares, the offering is sometimes structured under Rule 144A by selling only secondary shares to QIBs. In this way, a shareholder, and not the underwriter, is technically reselling the shares to the QIBs. Limiting US sales to secondary shares, however, means that US liability risks might be disproportionately borne by the selling shareholder. If there are not enough secondary shares or the secondary shares cannot be segregated, or if the offering is of primary shares only, the US portion of the offering can be structured under Section 4(a)(2) to QIBs. If the offering is of secondary shares only, the offering can be conducted under Rule 144A.

### Procedures

The procedures for Section 4(a)(2) to QIBs transactions can be very similar to those for a Rule 144A transaction, except for the absence of a resale of the securities:

- Offers and sales are made in the US to QIBs only.
- The same offering document that would otherwise be used for a Rule 144A offering is used. US securities law legends at the front of the document, but not the transfer restrictions, might differ slightly.
- The financial intermediaries receive the same Rule 10b-5 disclosure letters and SAS 72 comfort letters (*see boxes "Rule 10b-5 disclosure letter" and "SAS 72 comfort letter"*).
- The issuer provides the same representations and covenants in the placing or underwriting agreement, including the ongoing information covenant that relates to information required by Rule 144A(d)(4). By comparison, in a Section 4(1½) transaction, where there is a selling shareholder, the seller provides the same representations and covenants in the placing or underwriting agreement, other than the ongoing information covenant.

## Exemptions

Non-US issuers may be able to rely on the following exemptions from the registration requirements of US securities laws:

- The US Securities and Exchange Commission's Regulation D provides issuers with a safe harbour from the registration requirements of the US Securities Act of 1933 (Securities Act). Rule 506 of Regulation D allows issuers to sell their securities in a private placement to an unlimited number of accredited investors, provided that issuers comply with the general requirements of Regulation D.
- Section 4(a)(2) of the Securities Act (*see box "The Section 4(a)(2) exemption"*).
- Rule 144A under the Securities Act provides an exemption from the registration requirements for resales of securities to certain institutional buyers.
- Regulation S under the Securities Act provides a safe harbour from the registration requirements of the Securities Act for offers and sales of securities outside the US where certain conditions are fulfilled.

- QIBs do not sign investor representation letters, except where the securities being offered and sold are fungible with securities listed on a US exchange, in which case investor representation letters and other procedures would need to be considered.

In the UK, primary equity offerings by companies listing on the London Stock Exchange (and other offerings of equity securities) are usually structured as a direct primary sale from the issuer to the ultimate investor. Under the typical UK structure, the manager will only buy the shares if an investor defaults between the time the underwriting agreement is signed and the closing of the offering. Because Rule 144A is an exemption for resales, some argue that Rule 144A is not available and that Section 4(a)(2) to QIBs is the appropriate exemption for the manager's activities. A number of market participants take a different view.

In the UK structure, as in a traditional Rule 144A offering, the investment banks serve as intermediaries that bear the ultimate economic risk of the offering not being fully subscribed through a standby arrangement with the issuer. This so-called "Rule 144A direct" offering structure thus has no impact on economics, which are identical to the traditional Rule 144A offering. By contrast, in a classic Section 4(a)(2) offering, the issuer bears the economic risk if the placement agent (if any) does not find investors. Because the investment banks soliciting prospective investors bear the economic risk rather than the issuer in these offerings and are functionally indistinguishable from the intermediaries in a traditional Rule 144A offering, the applicable Section 5 exemption for their offering activities is interpreted by some market participants to be Rule 144A. Section 4(a)(2) is the exemption for the direct issuer sales to investors under this analysis even if Rule 144A is the exemption applicable to the manager's offering activities.

## NO RULE 10B-5 DISCLOSURE LETTER

In a typical offering of securities of a non-US company that is extended into the US, the underwriters will receive Rule 10b-5 disclosure letters, and the offering will be structured under Rule 144A or, in some cases, will be registered with the SEC. Investment banks take different approaches to whether to extend offerings of securities of non-US companies in the US in the absence of a Rule 10b-5 disclosure letter. Some banks will not do it at all, while others will only do it for offerings of debt securities. Of those that sometimes extend equity offerings to the US in this circumstance, some only do it in a limited manner for rights offerings (*see "Rights offerings by non-US companies" below*).

For those investment banks prepared to do so other than for rights offerings, one of two scenarios often apply:

- The offering was originally structured under Regulation S but, late in the process, the US is included; for example, as a result of a reverse inquiry from a potential investor in the US.
- The US portion of the offering is so small that, from a risk perspective, the managers are comfortable including the US without the more typical comfort of a Rule 10b-5 disclosure letter or, in many cases, a SAS 72 comfort letter.

A Section 4(a)(2) placement to QIBs is often the offering structure chosen in these scenarios. The managers take steps to support the argument that investors are not relying on them in making their investment decisions. Reliance is a requirement in a private Rule 10b-5 action (but not in an action by the SEC). Managers typically approach only a limited number of QIBs in these circumstances, and they ask the QIBs to sign investor representation letters. While there is no numerical limit, only a small number of QIBs that are known to the manager, or are known to the issuer or selling shareholder, are typically approached in the US in these circumstances.

The investor representation letter normally contains the following representations:

- The investor is satisfied with the level of information that it has received and is not relying on any investigation by, or representation from, the managers.
- The investor is a QIB.
- The investor understands that the securities are restricted.

Sometimes there are longer letters that contain so-called big boy or toxic language. These letters contain provisions in which the investor acknowledges certain risks of the securities or of the issuer, and the limited involvement of the placement agent. There are differing views on the effectiveness of toxic language.

## The Section 4(a)(2) exemption

Section 4(a)(2) is an exemption from the registration requirements of the US Securities Act of 1933 (Securities Act), for "transactions by an issuer not involving any public offering." In the domestic practice in the US, an issuer often approaches a small number of institutional investors and the investors subscribe to securities of the issuer. The investors typically sign a subscription agreement with the issuer and carry out their own due diligence.

Although there will often be a financial intermediary acting as a placement agent in Section 4(a)(2) transactions, the financial intermediary does not underwrite the securities, and may not even pass the securities through its books; this might be the case, for example, if the issuer is handling the sale itself in reliance on the Rule 3a4-1 safe harbour from the broker-dealer registration requirements under the US Securities Exchange Act of 1934, as amended, which may be available for certain securities offerings.

In domestic US Section 4(a)(2) transactions, companies often approach both qualified institutional buyers (QIBs) and accredited investors. While it is possible to offer and sell securities to non-QIB institutional investors in the US under Section 4(a)(2), those transactions typically involve different procedures. It is also possible (although rare) to use Section 4(a)(2) (without resort to certain safe harbours under Section 4(a)(2)) to sell to a limited number of individuals in the US. Again, different procedures are used in those transactions.

## Rule 10b-5 disclosure letter

Rule 10b-5 under the US Securities Exchange Act of 1934 (Rule 10b-5) provides that liability in connection with an offering document may arise if material information is omitted or materially misleading information is included. A Rule 10b-5 disclosure letter is a letter from lawyers confirming that, having undertaken certain due diligence procedures, they have no reason to believe that an offering document contains an untrue statement of material fact or omits to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

The managers often act as agents in connection with the US portion of the offering and do not buy and resell the securities. The securities are placed directly by the issuer with investors.

Because the portion of the offering structured in this way under Section 4(a)(2) to QIBs is usually part of a larger offering, it is not usually possible to reflect the more customary features of a domestic Section 4(a)(2) placement. For example, there would not likely be a separate subscription agreement between the issuer and the investor, or direct negotiations of the terms of the trade with the issuer. This structure can be used for both equity and debt securities.

## RIGHTS OFFERINGS BY NON-US COMPANIES

When a non-US company extends its rights offering into the US, it must register the rights offering with the SEC or structure the rights offering to comply with exemptions from the registration requirements of the Securities Act. There are three potential stages of a rights offering where exemptions need to be considered.

- Distribution of the rights to US shareholders. This is typically done without consideration, so it should not be treated as an offer or sale that needs to be registered with the SEC.
- Exercise of the rights by US shareholders or other US rights holders. There are several exemptions that will potentially be available. Rule 801 under the Securities Act, which is applicable if 10% or less of the shares are held of record by US holders, is sometimes, but rarely, used. Section 4(a)(2) to QIBs is an available exemption. Rule 144A frequently is not available for the exercise because it is not intermediated. (Regulation S is available for non-US shareholders and other non-US rights holders.)
- Placement of the rump. The portion of a rights offering not taken up by rights holders can be placed under a number of exemptions (and the rights offering may, or may not, be underwritten). Regulation S can be used if the managers exclude the US. If the managers include the US, the most common exemptions are Rule 144A and Section 4(1½). If the managers are placing the rump shares without buying and selling them, for example, in a non-underwritten rights offering, Section 4(a)(2) to QIBs is available. Section 4(a)(2) will not be available where the managers have underwritten and are buying and reselling the rump shares.

### Disclosure models

There are three disclosure models for rights offerings:

- Those extended into the US with a Rule 10b-5 disclosure letter.
- Those extended into the US without a Rule 10b-5 disclosure letter.
- Those excluding the US.

In a rights offering extended into the US with a Rule 10b-5 disclosure letter, the managers typically are involved in roadshows and in soliciting US shareholders. The offering document is written to a Rule 10b-5 standard. The managers also usually obtain a SAS 72 comfort letter. The exercise of the rights by US shareholders and other US rights holders is frequently structured under Section 4(a)(2) to QIBs, and the rump placement is typically structured under Rule 144A or as a Section 4(1½) to QIBs transaction. This is because the exercise of rights does not involve a resale, but the rump placement usually does.

In a rights offering extended into the US without a Rule 10b-5 disclosure letter, the offering document is typically prepared to a high standard, but not necessarily with the same level of information and degree of involvement by US-qualified attorneys and accountants as would be the case where Rule 10b-5 letters and SAS 72 comfort letters are delivered to the managers. The offering document frequently provides that shareholders in the US are excluded "subject to certain exceptions."

Those exceptions are typically QIBs approached under Section 4(a)(2). Usually, the issuer approaches its US shareholders that are QIBs directly, without involving the managers; the managers nevertheless often help the issuer confirm which of the issuer's US shareholders are QIBs. (Issuers would need to be mindful of considerations under the broker-dealer registration requirements in the US, especially if they approach US shareholders in this manner on a recurring basis.)

US shareholders and other US rights holders that are QIBs will exercise their rights under Section 4(a)(2). Under this model, the rump is typically not placed with

## SAS 72 comfort letter

The form and content of the most commonly used comfort letter in international offerings is governed by the US accounting profession's AU Section 634 "Letters for Underwriters and Certain Other Requesting Parties", and is generally referred to as SAS 72 as it was initially issued as Statement on Auditing Standards No 72. SAS 72 contains specific instructions that govern when, and to whom, a comfort letter may be issued, the scope of information that may be provided within a comfort letter, as well as examples of comfort letters that should be delivered in certain situations (*see feature article "SAS 72 letters: seeking comfort", www.practicallaw.com/1-525-4623*).

US investors because of liability concerns for the managers given the absence of a Rule 10b-5 disclosure letter.

In a rights offering excluding the US, US shareholders are not able to exercise their rights, and the rump is placed outside the US. The rights, if transferable, or new shares attributable to the excluded US shareholders, are often sold in the open market outside the US, with the net proceeds remitted to the US shareholders.

## M&A TRANSACTIONS

M&A transactions that involve an exchange of a bidder's securities for those of the target, as opposed to cash-only transactions, also implicate the registration requirements of the Securities Act. Some transactions might be able to benefit from exemptions from the registration requirements not generally applicable in other contexts, such as Section 3(a)(10) of the Securities Act (which could apply to a scheme of arrangement) or Rule 802 under the Securities Act (applicable if 10% or less of the shares of the target are held of record by US shareholders).

If the applicable non-US corporate law in a transaction allows differential treatment of certain holders of target securities, it also might be possible to use Section 4(a)(2) to exchange bidder securities for target securities held by certain US target shareholders (such as QIBs) without registering the transaction with the SEC. This could involve offering bidder shares only to those target shareholders that can certify that they are QIBs and applying procedures similar to those outlined above to satisfy the requirements of Section 4(a)(2).

The offering materials might provide, for example, that shareholders of the target in the US are excluded "subject to certain exceptions". Those exceptions are the QIBs approached under Section 4(a)(2). Section 4(a)(2) can be used in situations where Rule 802 is not available or where it is not practical to determine if it is available. The structure might not be appropriate if there is a large number of US retail shareholders. Such an approach would not be possible where the target's equity is listed in the US and the transaction is being structured as an exchange offer.

*Peter Castellon is a partner at Proskauer Rose (UK) LLP and Sebastian Sperber is a partner at Cleary Gottlieb Steen & Hamilton LLP.* *The authors would like to thank Leslie Silverman, a partner at Cleary Gottlieb, for his contribution to this article.*

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