September 2012

IFLR

INTERNATIONAL FINANCIAL LAW REVIEW

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All abroad

Many US emerging growth companies find it hard to raise capital at home. Here's why London and Oslo may provide good alternatives.

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For many small and mid-sized US issuers, international securities markets present an attractive alternative to an initial public offering (IPO) and listing in the US. The Oslo Stock Exchange (OSE), for instance, attracts international companies through its well-developed equity and debt markets in the energy, shipping and seafood sectors. London's Alternative Investment Market (AIM) also attracts emerging growth companies, for instance, energy exploration companies.

These are just two examples of regulated non-US markets that provide issuers with growth capital and public liquidity. The regulatory burden in these markets is generally less onerous than in the US, particularly following the passage of the Sarbanes-Oxley Act and Dodd-Frank Act. Compared to the US, the costs associated with an IPO, and subsequent reporting and other obligations, are considerably lower in other jurisdictions. The risk of shareholder class action lawsuits is also limited.

Early stage or growth companies often find it easier to attract investor attention abroad than in the US, where investment banks often prefer to work with – and analysts are more likely to follow – larger, more established companies.

However for many US companies, and non-US issuers whose voting securities are majority owned by US residents and do not otherwise qualify as foreign private issuers (collectively referred to as US domestic issuers), conducting an IPO overseas and listing on a non-US exchange are both very difficult.

"US domestic issuers interested in tapping non-US equity markets face significant impediments"

The electronic trading and settlement systems used in most non-US markets are incompatible with the requirements of the registration exemption for US domestic issuers provided for under Regulation S (Reg S) of US securities law.

Over a decade ago the Securities and Exchange Commission (SEC) issued no-action letters to a few non-US exchanges addressing concerns under Reg S. However this relief may not be relied on by issuers seeking to list on an exchange which did not receive the no-action letter. More recently, the SEC provided a no-action letter to Coach (the Coach Letter), a US reporting company which has its shares listed on the NYSE. The letter provided Coach and a US depositary with relief from certain Reg S requirements for the limited purpose of offering depositary receipts (representing its US listed common shares) in connection with a secondary listing on the Hong Kong Stock Exchange. The Coach Letter was issued provided that Coach, the Hong Kong Exchange and the US depositary agreed to a number of conditions, including a commitment by Coach that it would not raise any capital in connection with the transaction.

US domestic issuers interested in tapping non-US equity markets face significant impediments. The recently enacted Jumpstart Our Business Startups Act (JOBS Act), while not addressing Reg S directly, may assist domestic emerging growth companies in maneuvering these obstacles.

Securities law framework

US law generally requires issuers to file a registration statement with the SEC before offering its securities to the public - a process that is often complex, time consuming and expensive.

Unless an exemption applies, US companies making overseas offerings will be subject to the US registration process. The SEC has long recognised that offerings with minimal effect on US interstate commerce probably do not warrant SEC oversight. In 1990 the Commission clarified the extraterritorial application of the registration requirement by adopting Reg S, which provides a safe harbour for overseas offerings.

Reg S establishes certain requirements that an offering must satisfy to fall within the safe harbour. First, an offering must be made in an offshore transaction. This means it is not offered to a person in the US, and either the buyer is outside the US when the buy order is originated or the transaction is executed 'in, on or through a physical trading floor of an established foreign securities exchange that is located outside the United States.'

Secondly, neither the issuer nor its agents can make any 'directed selling efforts in the US.' Broadly speaking, this prohibits activity that may condition the US market, such as press releases or information about the offering on websites.

Finally, Reg S establishes three categories of offerings, two of which are subject to additional requirements. The categories distinguish issuers based on their being a foreign private issuer or a domestic issuer, a reporting or non-reporting company, or whether their primary trading market is in the US or abroad.

Category 1 covers foreign private issuers which do not have a substantial US market for the securities being offered. This category does not impose any restrictions in addition to the general offering conditions described above. Category 3 which applies to a US domestic issuer whether its securities are listed in the US, abroad, or not listed at all, establishes significantly more complex and detailed requirements. For Category 3 offerings, in general, neither an offer nor sale of securities can be made to a US person during what's known as the distribution compliance period. This period lasts for one year for equity of non-reporting issuers, and 40 days for debt.

Every purchaser during this period must certify that it is either a non-US person or is acquiring the securities in an exempt transaction. The purchaser must also agree to resell the securities only in compliance with Reg S, pursuant to registration, or pursuant to another available exemption (such as Rule 144A or Regulation D). Category 3 of Reg S also includes legending and stop transfer requirements.

Impediments to listing on European exchanges

Given securities on virtually all European exchanges are traded in dematerialised form, it may not be possible for US domestic issuers to comply strictly with Reg S. Even if allowed, paper settlement in an electronic market will negatively impact liquidity. As a result, many US domestic issuers are effectively excluded from international primary markets.

Interestingly, when the legend and certification requirements were proposed, the SEC indicated in a proposing release that dematerialised securities may still satisfy the legend requirement. Specifically, the SEC provided that systems that are "reasonably designed" to put holders and subsequent purchasers on notice of these restrictions could satisfy this requirement.

The SEC provided no-action letters to the OM Stockholm Exchange (2000), the Australian Stock Exchange (2000) and a trading system which no longer exists, but has never elaborated on the kind of systems that may satisfy the standard of reasonable design.

Nevertheless, a few European stock exchanges have endeavored to develop innovative electronic trading and settlement systems which are designed to serve the policy goals of Reg S, even if they are not in strict compliance with its requirements. Two of these exchanges are the London Stock Exchange's AIM and the OSE.

AIM

AIM is the LSE's market for growth companies. It is an exchange regulated market (rather than an EU-regulated market) which means that an issuer can be admitted to AIM without being required to prepare a prospectus that complies with the EU's Prospectus Directive. An issuer may be required to produce a Prospectus Directive-compliant prospectus if it will be making an offer to the public, however, unless that offer complies with an exemption.

To be admitted to AIM, there is no requirement for issuers to demonstrate minimum capitalisation levels or that a set percentage of their shares are held by the public. By providing a less regulated marketplace with lower fixed costs than a US IPO and listing, AIM may allow companies to access public capital markets at an earlier stage in their development.

US companies admitted to AIM participate in a special paper trading system. In order to ensure compliance with Reg S, the system provides for certificated securities and a certification from each purchaser that it is a non-US person, a US person acquiring the securities in an exempt transaction, or a transaction not requiring registration.

Unfortunately for issuers participating in this system, the requirements have a significant negative impact on liquidity with trades potentially taking weeks to settle. Despite this reduced liquidity, an AIM admission provides US domestic issuers with the benefits of an organised secondary market, research coverage and an improved investor profile without the burden of extensive US securities regulations.

In 2006, in response to concerns about liquidity, the London Stock Exchange introduced an alternative electronic settlement service (SIS) to allow for the trading on AIM of companies' shares that are subject to Reg S. SIS allows a purchasing broker to enter information regarding a Reg S trade into its own computer system, including the nationality of the purchaser. These details are transmitted to SIS, and so long as the information shows that the purchaser is not a US person, the trade will be settled.

By requiring the member firms to agree to certain conditions, this electronic settlement system seeks to comply with Reg S. For example, prior to purchasing a Reg S security, a firm must take reasonable steps to ascertain under LSE rules whether its client may be considered a US person. Member firms must also design, implement, and maintain measures to assure compliance. This includes obtaining client certification that they are not

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US persons within the meaning of Reg S, and that they accept the restrictions and limitations imposed by Reg S.

Further, securities subject to Reg S trade in a self-contained sector and remain there until the issuer notifies the LSE that the restrictions no longer apply. Those securities are marked REG S so that purchasers know the securities are restricted.

The rules of the LSE's main market also impose obligations on member firms not to trade in Reg S securities unless they have a reasonable basis to believe that the trade complies with US law requirements.

Even though these certifications and agreements are not given in physical form, the electronic system ensures the securities are not sold to US persons during the distribution compliance period. In practice however, because the SEC has not yet blessed this system, US domestic issuers generally have been unwilling to rely on the SIS system for fear of violating the registration requirements under US law.

OSE

The OSE is a liquid market focused on issuers in the energy (including offshore services and related technologies), shipping and seafood sectors. The energy sector accounts for over half of the market. It ranks second in Europe for the number of energy companies listed on its exchange and it is the second largest market in the world for companies in the oil services sector. The investment banks, research analysts and other advisors in this market have significant experience regarding these industries.

To address Category 3 issuers, the OSE has adopted rules similar to those used by the LSE. Like the LSE, the OSE places the onus of not trading Reg S securities on the broker. Specifically, the broker must have a reasonable basis to believe that any trades comply with Reg S. The issuer will identify a Reg S security and the OSE will require that the letters REG S be added to the end of the securitiy's name when shown on the exchanges' trading system, TradElect.

The Reg S securities are placed in a separate sector during the distribution compliance period. Once the issuer notifies the OSE that the restrictions no longer apply, the REG S marker is removed and it will be taken out of the separate sector. To facilitate the identification of these securities, a list of any Reg S traded securities is made available on the OSE's website.

The OSE has developed additional safeguards similar to the SIS system that could be implemented to further protect against the flow back of securities into the US. As with the LSE, the OSE trading and settlement system has not been blessed by the SEC. Consequently, very few US domestic issuers are listed on the OSE.

Potential solutions

Since the no-action relief provided in 1999 and 2000 does not apply universally, and the Coach Letter is limited to secondary listing transactions by reporting issuers in which no capital is raised, it is difficult for a US domestic issuer to structure an IPO and listing abroad. Without the SEC's explicit approval of electronic trading and settlement systems, issuers, transfer agents, depositaries, underwriters and exchanges are left in a precarious position.

There are some structures that a US domestic issuer could potentially use to navigate this uncertainty, however, plus some measures the US government could implement to resolve it.

Redomicile

A US issuer could redomicile into a non-US jurisdiction. This is a complex undertaking and may in some situations be impracticable due to the expense involved or potentially significant adverse tax consequences.

In addition, a redomiciled company must qualify as a foreign private issuer. This requires 50% or more of the issuer's outstanding voting securities to be owned of record by non-US persons. Alternatively, if US ownership is directly or indirectly over 50%, then a majority of the issuer's executive officers and directors must not be US citizens or residents, more than 50% of the issuer's assets must be located outside the US, and the issuer must not be principally administered in the US.

Complying with these requirements may not be achievable as the sponsors or majority owners of the company, if US citizens, may have to relinquish control of the company or move the operations and management completely offshore. If the issuer's business is conducted in the US – an oil and gas or mining operation for example – it may be impossible to develop a structure that places 50% of its assets outside of the US. Although redomiciling is a solution that has been used, it can be expensive and time-consuming, and requires careful advanced planning.

Listing without raising capital

Another option is to list currently outstanding shares on a non-US exchange without also raising capital. To the extent a company's shares are no longer restricted, those securities could be listed on many non-US exchanges which are designated offshore securities markets under Reg S. This is because resales of those securities, by shareholders who are not deemed affiliates, should be exempt under Reg S without any requirement to comply with Category 3 distribution and compliance requirements.

However, procedures will need to be developed for resales by those affiliates as those sales are covered by the Category 3 distribution compliance period. Potentially more problematic, when the company needs to raise additional capital these offerings will have to be registered or comply with Reg S. The issuer will likely have to issue any such securities in a separate class that is not listed on the non-US exchange. Therefore, the securities sold in subsequent offerings, particularly equity securities, would be less liquid than the listed securities for a significant period of time.

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US registration

A third option is to register the offer and sale of all shares in the offering with the SEC and seek a dual listing in the US and abroad, or seek only a non-US listing. This eliminates the need to rely on Reg S.

Most companies considering a primary listing abroad are small-to-medium sized companies with less than $1 billion gross revenue and will likely qualify as emerging growth companies (EGC) under the JOBS Act.

These companies can take advantage of the reduced regulatory burden offered under the new law. For example, EGCs benefit from scaled disclosure requirements and are exempt from Sarbanes-Oxley Act audit requirements, compensation discussion and analysis rules, and say-on-pay under Dodd-Frank. Equally important are the material changes to the IPO process for EGC's implemented through the JOBS Act. These relate to institutional investor meetings, confidential submission of registration statements and liberalised analyst communications. This legislation has to a great extent aligned the US and European IPO process for EGCs. It may also be possible to combine this approach with a redomiciling strategy that allows the issuer to qualify as a foreign private issuer at, or before, the time it reaches the end of the JOBS Act on-ramp, after which it becomes obligated to comply with some of the more difficult US regulatory requirements.

An issuer considering this option should also analyse whether it is possible to expand the relief granted in the Coach Letter to include a capital raising transaction in which the domestic issuer becomes a US reporting company. Given the enactment of the JOBS Act, registering the offer and sale of securities to be offered and listed abroad is much more issuer-friendly than it would have been just a short time ago. It may provide a viable option for US domestic issuers which qualify as emerging growth companies.

Legislative or regulatory action

To alleviate the regulatory uncertainty and streamline the capital raising process, the US government could take steps to clarify this process while still protecting the interests of US investors.

The SEC could, through an interpretive release, explicitly establish parameters under which dematerialised trading and settlement systems satisfy Reg S. Or it could build upon the relevant statements in Reg S's proposing and adopting releases, and through additional no-action letters, expand the Coach Letter's relief to include capital raising transactions, particularly if the US domestic issuer is, or as a result of the transaction will be, a US reporting issuer.

Congress could directly address the situation, as it did in the JOBS Act. Some policymakers may be hesitant to facilitate international offerings because they prefer domestic issuers to raise capital in the US. The JOBS Act appears to embody this preference by exempting EGCs from certain requirements under Sarbanes-Oxley and Dodd-Frank which many believe hurt the US IPO market. The Act also provides certain US domestic issuers benefits that had previously been available only to foreign private issuers.

US policy, however, has traditionally supported the free flow of capital across national borders. US domestic issuers would benefit from increased access to capital. Any changes to Reg S that remove the existing impediments that distort the free flow of capital from mature regulated international markets to US domestic issuers would be a positive development.