ACCESSING THE U.S. CAPITAL MARKETS

U.S. ISSUERS

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TABLE OF CONTENTS

ACCESSING THE U.S. CAPITAL MARKETS

Page

INTRODUCTION 1

AN OVERVIEW OF U.S. SECURITIES REGULATORS AND LAWS 2

SECTION I. PRELIMINARY MATTERS 25

CHAPTER 1 THE OFFERING PROCESS 26

CHAPTER 2 PRE-OFFERING MATTERS 71

SECTION II. REGISTERED PUBLIC OFFERINGS 78

CHAPTER 3 THE SECURITIES REGISTRATION AND REPORTING PROCESS 79

CHAPTER 4 DISCLOSURE REQUIREMENTS 93

CHAPTER 5 SHELF REGISTRATION 160

CHAPTER 6 LISTING ON U.S. SECURITIES EXCHANGES 171

SECTION III. ONGOING COMPLIANCE OBLIGATIONS 215

CHAPTER 7 ONGOING REPORTING AND OTHER REQUIREMENTS 216

SECTION IV. EXEMPT OFFERINGS, SECURITIES AND ISSUERS 255

CHAPTER 8 EXEMPT OFFERINGS AND SECURITIES 256

CHAPTER 9 1940 ACT-EXEMPT ISSUERS 282

SECTION V. SELECTED ISSUERS 295

CHAPTER 10 FINANCE SUBSIDIARIES 296

CHAPTER 11 REITS 305

CHAPTER 12 MASTER LIMITED PARTNERSHIPS 313

CHAPTER 13 BANK ISSUERS 320

CHAPTER 14 INSURANCE COMPANY ISSUERS 333

SECTION VI. OTHER MATTERS 345

CHAPTER 15 REPURCHASING, EXCHANGING AND AMENDING AN ISSUER'S OUTSTANDING SECURITIES 346

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CHAPTER 16 LIABILITIES UNDER U.S. SECURITIES LAWS 359

CHAPTER 17 DE-REGISTERING UNDER THE 1934 ACT 372

CHAPTER 18 ACQUISITIONS OF U.S. ENTITIES 377

CHAPTER 19 ACQUISITION FINANCE IN THE CAPITAL MARKETS 392

GLOSSARY 408

APPENDIX A

NYSE AND THE NASDAQ: LISTING REQUIREMENTS FOR COMMON STOCK A-1

APPENDIX B

DETERMINING WHETHER AN ISSUER IS A PRIMA FACIE INVESTMENT COMPANY OR EXEMPT PURSUANT TO RULE 3a-1 UNDER THE INVESTMENT COMPANY ACT OF 1940 .... B-1

APPENDIX C

DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE AND RELATED INFORMATION C-1

APPENDIX D

SUMMARY OF SEC RELEASES ON MD&A D-1

APPENDIX E

REGULATION OF ACTIVITIES OF U.S. BANKS IN THE UNITED STATES E-1

APPENDIX F

FORM 8-K DISCLOSURE REQUIREMENTS CHART F-1

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DETAILED TABLE OF CONTENTS

Page

INTRODUCTION **1**

AN OVERVIEW OF U.S. SECURITIES REGULATORS AND LAWS **2**

GENERAL **2**

SECURITIES INDUSTRY REGULATORS **3**

The Securities and Exchange Commission 3
The Financial Industry Regulatory Authority 3
The Public Company Accounting Oversight Board 4
U.S. Securities Exchanges 4
State and Territorial Securities Regulators 5
Federal and State Bank and Thrift Regulators 5
The Commodity Futures Trading Commission 6

SECURITIES ACT OF 1933 ..... **6**

Purpose 6
Registration 6
Prospectuses 7
Trading Restrictions 7

SECURITIES EXCHANGE ACT OF 1934 ..... **7**

Purpose 7
Registration and Periodic Reporting 8
Proxy Statements 9
Section 16 Reporting and Profit Recapture 9
Tender Offers 10

SARBANES-OXLEY ACT OF 2002 ..... **11**

Purpose 11
Disclosure and Related Requirements 11
Audit, Auditor and Audit Committee Requirements 12
Other Requirements 13
Application 13

SECURITIES OFFERING REFORM OF 2005 ..... **14**

THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010 ..... **15**

Purpose 15
Compensation, Compensation Adviser and Compensation Committee Requirements 15
Corporate Governance 16
Specialized Corporate Disclosure 16
Credit Ratings 17
Other Requirements 17

THE JUMPSTART OUR BUSINESS STARTUPS ACT OF 2012 ..... **18**

Purpose 18
Relief for Emerging Growth Companies 18
General Solicitation 19
The New Crowdfunding Exemption 19

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Expanded Small Public Offering Exemption 20
1934 Act Section 12(g) Registration 20
Status of JOBS Act Rule Making 20

TRUST INDENTURE ACT OF 1939 21

Purpose 21
Qualification 21

INVESTMENT COMPANY ACT OF 1940 22

Purpose 22
Registration 22

"BLUE SKY" OR STATE SECURITIES LAWS 22

Purpose 22
Federal Preemption 23
Registration 23

SECTION I. PRELIMINARY MATTERS 25

CHAPTER 1 THE OFFERING PROCESS 26

GENERAL 26

INITIAL CONSIDERATIONS 27

Stand-Alone Offering or Program 27
1933 Act-Registered or Not 28
U.S. Only or International Offering 29

OVERVIEW OF THE U.S. OFFERING PROCESS 30

ISSUER CLASSES 34

WKSIs 34
Seasoned Issuers 35
Unseasoned Issuers 35
Voluntary Filer Status 35
Non-Reporting Issuers 36
Ineligible Issuers 36
EGCs 37

OFFERING DOCUMENTS 38

"Test-the-Waters" Communication by EGCs 38
Free Writing Prospectus 39
Written Communications 41
Graphic Communications 42
Primary Offering Document 42
Prospectus Delivery 43
Information Incorporated by Reference 44
Other Information in the Disclosure Package 46
Disclosure Package at Time of Sale 46

DUE DILIGENCE 46

Origins and Purpose 47
Main Aspects of Due Diligence 48

LIMITATIONS ON PUBLICITY 52

Rules That Apply to a 1933 Act-Registered Offering 52

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Rules that Apply to Unregistered Offerings, Including Rule 144A Offerings 55

RESEARCH REPORTS 56

Research by Non-Participating Broker or Dealer 56
Research by Participating Broker or Dealer 57
Issuer and Industry Research Reports 57

ROADSHOWS 58

Physical Roadshows 58
Electronic Roadshows 59
SEC Filing Requirements 59

STABILIZATION AND REGULATION M 60

Restrictions on the Activities of Issuers, Selling Securityholders and Their Affiliated Purchasers 60
Restrictions on the Activities of Distribution Participants and Their Affiliated Purchasers 62
Affiliated Purchasers of Issuers, Selling Securityholders and Distribution Participants 63
NASDAQ Passive Market Making 64
Stabilizing Transactions 65
Short Selling in Connection with a Public Offering 69

CHAPTER 2 PRE-OFFERING MATTERS 71

GENERAL 71

PREPARING THE TEAM 71

PREPARING THE BUSINESS PROFILE 72

EGC STATUS AND BENEFITS 73

SELECTING A JURISDICTION OF INCORPORATION 73

PREPARING THE CORPORATE ENTITY 74

THE COVENANT STRUCTURE FOR DEBT OFFERINGS 76

THE 1940 ACT 76

ACCOUNTING MATTERS 77

SECTION II. REGISTERED PUBLIC OFFERINGS 78

CHAPTER 3 THE SECURITIES REGISTRATION AND REPORTING PROCESS 79

REGISTRATION UNDER THE 1933 ACT 79

"S" Forms 80

THE SECURITIES REGISTRATION PROCESS 80

Plain English Disclosure 81
Electronic Filing and Fees 82
Staff Review and Comment 82
FINRA Review 83
Solicitations of Interest 84
Shelf Registration 84
Summary Form Eligibility Chart 84
Eligibility Requirements of Forms S-1 and S-3 86

REGISTRATION AND REPORTING UNDER THE 1934 ACT 89

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General ... 89
1934 Act Reporting Forms for U.S. Issuers ... 90

CHAPTER 4 DISCLOSURE REQUIREMENTS ... 93

GENERAL ... 93

RELATIONSHIP BETWEEN "S" FORMS AND 1934 ACT REPORTS ... 93

DISCLOSURE REQUIREMENTS OF THE "S" FORMS AND 1934 ACT FILINGS ... 94

SIGNATURES AND CERTIFICATIONS ... 127

REDUCED DISCLOSURE REQUIREMENTS FOR EGCS ... 129

CURRENT REPORTS: DISCLOSURE AND SIGNING REQUIREMENTS OF FORM 8-K ... 130

DISCLOSURE REQUIREMENTS OF PROXY STATEMENTS ... 133

Schedule 14A ... 133
Pending Proxy Statement Disclosure Requirements ... 156

DISCLOSURE REGARDING NON-GAAP FINANCIAL MEASURES ... 157

CHAPTER 5 SHELF REGISTRATION ... 160

GENERAL ... 160

SECURITIES COVERED BY RULE 415 ... 160

SHELF REGISTRATION PROCEDURES ... 162

Automatic Shelf Registration Statements ... 162
Other Shelf Registration Procedures ... 165
Documentation ... 167

SHELF UPDATING PROCEDURES ... 168

Rule 415 Undertakings ... 168

DUE DILIGENCE ... 169

CHAPTER 6 LISTING ON U.S. SECURITIES EXCHANGES ... 171

GENERAL ... 171

LISTING EQUITY SECURITIES ON THE NYSE AND THE NYSE ARCA ... 172

NYSE and NYSE Arca Process for Listing Equity Securities ... 172
NYSE and NYSE Arca Fees for Listing Equity Securities ... 173
NYSE and NYSE Arca Standards for Listing Equity Securities ... 175
NYSE and NYSE Arca Corporate Governance Requirements ... 179
Rights Offerings ... 187
NYSE and NYSE Arca Continued Listing Requirements ... 187

LISTING EQUITY SECURITIES ON THE NYSE MKT ... 188

NYSE MKT Process for Listing Equity Securities ... 188
NYSE MKT Fees for Listing Equity Securities ... 189
NYSE MKT Standards for Listing Equity Securities ... 189
NYSE MKT Continued Listing Requirements ... 195

LISTING EQUITY SECURITIES ON THE NASDAQ MARKETS ... 196

Nasdaq Process for Listing Equity Securities ... 196
Nasdaq Fees for Listing Equity Securities ... 196

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Nasdaq Standards for Listing Equity Securities 198
Nasdaq Continuing Listing Standards 205

LISTING CERTAIN SECURITIES OTHER THAN EQUITY SECURITIES 206

Listing Debt Securities on the NYSE 206
Listing Debt Securities on the NYSE Arca 206
Listing Equity-Linked Debt Securities on the NYSE 207
Listing Equity-Linked Term Notes ("ELTNs") on the NYSE MKT and the NYSE Arca 210
Listing Preferred Stock on the NYSE and the NYSE Arca 212
Listing Preferred Stock on the NYSE MKT 214

SECTION III. ONGOING COMPLIANCE OBLIGATIONS 215

CHAPTER 7 ONGOING REPORTING AND OTHER REQUIREMENTS 216

GENERAL 216

HOLDERS OF RECORD 217

PERIODIC REPORTING REQUIREMENTS 218

Periodic SEC Reporting 218
U.S. Securities Exchange Reporting 219
Proxy Statements 220
Reports to Shareholders 220

EXTENSIBLE BUSINESS REPORTING LANGUAGE ("XBRL") 221

SARBANES-OXLEY 222

Disclosure and Related Requirements 223
Audit, Auditor and Audit Committee Requirements 228
Requirements for Attorneys Representing Issuers 232
Miscellaneous Requirements 234

BENEFICIAL OWNERSHIP REPORTING UNDER SECTION 13 237

INSIDER TRADING AND SHORT SWING PROFIT RULES 238

PROXY RULES 238

COMMUNICATIONS WITH INVESTORS AND THE PUBLIC 239

Press Releases 239
Communications with Analysts 239
Materiality Standards 240
Duty to Disclose 240
Regulation FD 241
Procedures to Guard Against Inadvertent Selective Disclosure 250

FOREIGN CORRUPT PRACTICES ACT OF 1977 ("FCPA") 251

THE OFFICE OF FOREIGN ASSETS CONTROL ("OFAC") 253

SECTION IV. EXEMPT OFFERINGS, SECURITIES AND ISSUERS 255

CHAPTER 8 EXEMPT OFFERINGS AND SECURITIES 256

GENERAL 256

EXEMPT OFFERINGS UNDER THE 1933 ACT 256

Private Placements 257

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Regulation S Offerings ... 267

EXEMPT SECURITIES UNDER THE 1933 ACT ... 279

Commercial Paper ... 279
Securities Issued or Guaranteed by a Bank or a Regulated U.S. Branch or Agency of a Non-U.S. Bank ... 280
Exchanged Securities ... 280
Other Exempt Securities ... 281

CHAPTER 9 1940 ACT-EXEMPT ISSUERS ... 282

GENERAL ... 282

NON-PRIMA FACIE INVESTMENT COMPANIES ... 283

RULE 3A-1 ISSUER ... 284

TRANSIENT INVESTMENT COMPANIES ... 284

COMMERCIAL PAPER FINANCE SUBSIDIARIES ... 285

FINANCE SUBSIDIARIES ... 285

NON-U.S. BANKS, INSURANCE COMPANIES AND SIMILAR INSTITUTIONS ... 286

STRUCTURED FINANCING VEHICLES ... 286

CERTAIN RESEARCH AND DEVELOPMENT COMPANIES ... 289

PRIVATE INVESTMENT FUNDS ... 290

Section 3(c)(1) Exemption ... 290
Qualified Purchaser Exemption ... 291

ENTITIES PRIMARILY ENGAGED IN HOLDING RECEIVABLES, REAL ESTATE OR MORTGAGES ... 293

ENTITIES ENGAGED IN THE OWNERSHIP OF OIL OR GAS ASSETS ... 294

SECTION V. SELECTED ISSUERS ... 295

CHAPTER 10 FINANCE SUBSIDIARIES ... 296

GENERAL ... 296

1933 ACT CONSIDERATIONS ... 296

1940 ACT CONSIDERATIONS ... 297

Rule 3a-5 ... 297
Rule 3a-3 ... 301
Rule 3a-7 ... 301
Section 3(c)(1) ... 301
Section 3(c)(5) ... 302
Section 3(c)(7) ... 302

SUPPORT AGREEMENTS ... 302

RATING AGENCY REQUIREMENTS ... 302

1933 ACT AND 1934 ACT REGISTRATION AND REPORTING ISSUES ... 303

CHAPTER 11 REITS ... 305

BACKGROUND AND HISTORY OF REITS ... 305

U.S. INTERNAL REVENUE CODE PROVISIONS ... 306

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UPREITS AND DOWNREITS **307**

REIT DEBT OFFERINGS **308**

MORTGAGE OR SPECIALTY FINANCE REITS VS. EQUITY REITS **309**

SEC'S Concept Release and Review 311

FUNDS FROM OPERATIONS **311**

CHAPTER 12 MASTER LIMITED PARTNERSHIPS **313**

BACKGROUND **313**

TYPICAL CAPITAL STRUCTURE **313**

Publicly Held Interests 314
Sponsor's Interests 315

GOVERNANCE **316**

U.S. FEDERAL TAX ASPECTS **317**

Sponsors 317
Public Investors 317

STATE AND LOCAL TAXATION **318**

POTENTIAL TAX REFORM **318**

CHAPTER 13 BANK ISSUERS **320**

GENERAL **320**

Characteristics of Bank Securities 321
Institutional Certificates of Deposit and Deposit Notes 321
Regulation D 322
Equity-Linked and Credit-Linked Securities 323

STATUS UNDER THE FEDERAL SECURITIES LAWS **323**

1933 ACT CONSIDERATIONS **325**

U.S. Banks 325
U.S. Branches and Agencies of Non-U.S. Banks 325
Direct Issuances by Bank Holding Companies 325

APPLICATION OF SECURITIES OFFERING REGULATIONS OF THE BANK REGULATORY AGENCIES **326**

OCC Regulations 326
Federal Reserve Board and FDIC 327

1934 ACT CONSIDERATIONS **327**

1939 ACT CONSIDERATIONS **328**

1940 ACT CONSIDERATIONS **329**

BLUE SKY LAWS **329**

FINRA CONSIDERATIONS **330**

CHAPTER 14 INSURANCE COMPANY ISSUERS **333**

GENERAL **333**

STOCK INSURANCE COMPANIES **333**

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MUTUAL INSURANCE COMPANIES **334**

RECIPROCAL INSURANCE EXCHANGES **335**

MUTUAL INSURANCE HOLDING COMPANIES **336**

STATE-BASED REGULATION **336**

Statutory Accounting vs. GAAP 337
Change of Control Filings 337
Blue Sky Securities Laws 338
Federal Regulation and the Optional Federal Charter 338
Dodd-Frank Orderly Liquidation Authority 339

DUE DILIGENCE AND DISCLOSURE **340**

Due Diligence 340
Disclosure 341

FEDERAL SECURITIES LAWS AND CERTAIN INSURANCE PRODUCTS **343**

Section 3(a)(8) 343
Indexed Annuities and Rule 151A 343

SECTION VI. OTHER MATTERS **345**

CHAPTER 15 REPURCHASING, EXCHANGING AND AMENDING AN ISSUER'S OUTSTANDING SECURITIES **346**

GENERAL **346**

Rule 10b-5 Considerations 347
Purchases in the Open Market and Privately Negotiated Transactions 347
Tender Offers 348

PRIMARY SEC RULES AND REGULATIONS GOVERNING EQUITY SELF TENDER OFFERS **349**

Regulatory Framework 349
Timing 351
Procedures 351
Withdrawal Rights 352
Proration 352
Prompt Payment 353
Purchases Outside the Tender Offer 353
All Holders; Best Price 353
Pricing of Equity Tender Offers 353

PRIMARY SEC RULES AND REGULATIONS GOVERNING DEBT SELF TENDER OFFERS **354**

Debt Tender Offer Purchase Price Determination 355

EXCHANGE OFFERS **357**

CONSENT SOLICITATIONS **358**

CHAPTER 16 LIABILITIES UNDER U.S. SECURITIES LAWS **359**

GENERAL **359**

1933 ACT REGISTRATION STATEMENT LIABILITY **360**

General 360
Scope of Liability 360

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Due Diligence Defense ... 361
Damages ... 362
Limitation on Actions ... 362

1933 ACT REGISTRATION VIOLATIONS; PROSPECTUS LIABILITY ... 363

Registration Violations ... 363
Prospectus Liability ... 363
Section 12(a)(2) Seller Liability ... 365
Damages ... 366
Limitation on Actions ... 366

1934 ACT – MANIPULATIVE OR DECEPTIVE DEVICES ... 367

Damages ... 369
Limitation on Actions ... 369

1934 ACT – INSIDER TRADING ... 369

CONTROLLING PERSON LIABILITY ... 370

CLASS ACTIONS ... 370

SEC ENFORCEMENT POWERS AND CRIMINAL SANCTIONS ... 370

SEC Enforcement Powers ... 371
Criminal Sanctions ... 371

SARBANES-OXLEY ... 371

CHAPTER 17 DE-REGISTERING UNDER THE 1934 ACT ... 372

GENERAL ... 372

ENDING REPORTING OBLIGATIONS ... 373

HOLDERS OF RECORD ... 374

CHAPTER 18 ACQUISITIONS OF U.S. ENTITIES ... 377

INTRODUCTION ... 377

STRUCTURAL MATTERS ... 377

Asset Purchase ... 377
Stock Purchase ... 378
Merger ... 378
Other Variations ... 378
Forms of Payment ... 379

SELECTED RELATED MATTERS ... 379

Antitrust Issues ... 380
Insider Trading and Disclosure of Information ... 380
Schedules 13D and 13G ... 380
Section 16 ... 380
Sarbanes-Oxley ... 381

TENDER OFFERS AND EXCHANGE OFFERS; COMMUNICATIONS UNDER THE 1933 ACT ... 381

Required Disclosure ... 382
Communications under the Tender Offer Rules ... 383

PROXY SOLICITATIONS ... 383

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CROSS-BORDER RULES **384**

Tier I Exemption 384
Tier II Exemption 384
Exemptions from Rule 14e-5 385

OVERVIEW OF OTHER SELECTED LEGAL ISSUES **385**

Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR Act") 385
Other Federal and State Law Requirements Relevant to Non-U.S. Acquirors 386
Internal Revenue Code 388
Exon-Florio Amendment 388
State Corporate Law; Other Impediments 389

CONCLUSION **391**

CHAPTER 19 ACQUISITION FINANCE IN THE CAPITAL MARKETS **392**

GENERAL **392**

GENERAL FINANCIAL STATEMENT REQUIREMENTS **393**

Regulation S-X Applies Only if the Acquisition is Probably or has Occurred 393
Determining the Level of Significance under Regulation S-X 394
Target Historical Financial Statement Requirements 394
Pro Forma Financial Statement Requirements 395
Time Frame in Which Acquisition Financial Statements Must be Provided 395
Already Effective Shelf Registration Statements 396

ADDITIONAL TARGET DISCLOSURE **397**

Transactional Disclosure 397
Target Disclosure 397
Factors Impacting Degree of Historical Target Disclosure 399
Issues to Consider in Providing Inclusion of Historical Target Data 400

PRIVATE PLACEMENTS VERSUS REGISTERED OFFERINGS **403**

STRUCTURAL CONSIDERATIONS AND FORMAT OF THE SECURITIES OFFERING **404**

Mandatory Redemption if Acquisition is not Consummated 404
Convertible Securities 404

GLOSSARY **408**

APPENDIX A NYSE AND NASDAQ: LISTING REQUIREMENTS FOR COMMON STOCK **A-1**

APPENDIX B DETERMINING WHETHER AN ISSUER IS A PRIMA FACIE INVESTMENT COMPANY OR EXEMPT PURSUANT TO RULE 3A-1 UNDER THE INVESTMENT COMPANY ACT OF 1940 ..... **B-1**

DEFINITIONS **B-1**

PRIMA FACIE INVESTMENT COMPANY **B-3**

RULE 3A-1 ..... **B-4**

APPENDIX C DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE AND RELATED INFORMATION **C-1**

GENERAL **C-1**

SCOPE OF APPLICATION **C-2**

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OPERATING SEGMENTS.......... C-3

Definition C-3
Enterprise Segments Reporting Guidelines.......... C-4

REQUIRED DISCLOSURE C-5

General Information.......... C-5
Information about Profit or Loss, Assets and the Basis of Measurement C-5
Reconciliations of Segment Revenues, Reported Profit or Loss, Assets and Other Significant Items to the Corresponding Enterprise Amounts.......... C-7
Interim Period Information C-7
Restatement of Previously Reported Information C-8

ENTERPRISE-WIDE DISCLOSURE C-8

Information about Products and Services.......... C-8
Information about Geographic Areas.......... C-8
Information about Major Customers C-9

APPENDIX D SUMMARY OF SEC RELEASES ON MD&A.......... D-1

THE JANUARY 2002 RELEASE.......... D-1

Liquidity and Capital Resources, Including Off-Balance Sheet Arrangements D-2
Non-Exchange Traded Contracts Accounted for at Fair Value.......... D-4
Related Party and Similar Transactions D-5

THE DECEMBER 2001 AND MAY 2002 RELEASES (CRITICAL ACCOUNTING POLICIES) D-6

THE JANUARY 2003 RELEASE.......... D-8

Off-Balance Sheet Arrangements.......... D-8
Contractual Obligations D-10
Liability Matters.......... D-11

THE DECEMBER 2003 RELEASE.......... D-11

Presentation of MD&A D-11
Content and Focus of MD&A D-12
Focus on Materiality D-12
Key Performance Indicators.......... D-13
Focus on Material Trends and Uncertainties.......... D-13
Focus on Analysis D-13
Liquidity & Capital Resources.......... D-14
Cash Requirements D-14
Sources and Uses of Cash D-15
Debt Instruments, Guarantees and Related Covenants.......... D-16
Cash Management.......... D-16
Critical Accounting Estimates.......... D-16

MD&A DISCLOSURE ON FAIR VALUE.......... D-17

THE FEBRUARY 2010 RELEASE (CLIMATE CHANGE).......... D-21

THE SEPTEMBER 2010 INTERPRETIVE RELEASE AND PROPOSED RULE.......... D-22

Interpretive Release for Current Disclosure Requirements in the MD&A of Financial Condition and Results of Operation.......... D-22
Proposed Rule for Short-Term Borrowings D-24

THE OCTOBER 2011 RELEASE (CYBERSECURITY) D-25

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DIVISION OF CORPORATION FINANCE: DISCLOSURE GUIDANCE ... D-26

APPENDIX E REGULATION OF ACTIVITIES OF U.S. BANKS IN THE UNITED STATES ... E-1

LEGAL FRAMEWORK ... E-1

Supervision of Banks ... E-1
Bank Holding Companies and Bank Holding Company Act ... E-1
Financial Holding Companies ... E-2

THE DODD-FRANK ACT ... E-3

Affiliate Transaction Restrictions ... E-3
Resolution Plans (Living Wills) ... E-7
Volcker Rule ... E-10
Derivatives Regulation ... E-16
Capital, Leverage and Liquidity Requirements ... E-18

BASEL III ... E-20

Brief History Leading Up to Basel III ... E-20
Overview of Basel III ... E-21
U.S. Implementation of Basel III ... E-25

MONEY LAUNDERING AND TERRORIST FINANCING ... E-34

Anti-Money Laundering ... E-34
OFAC Compliance ... E-36

APPENDIX F FORM 8-K DISCLOSURE REQUIREMENTS CHART ... F-1

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INTRODUCTION

Accessing the U.S. Capital Markets is a basic primer for entities interested in accessing the U.S. capital markets by conducting a securities offering, listing on a U.S. securities exchange or acquiring a U.S. company. This is one of three *Accessing the U.S. Capital Markets* volumes that we publish. This volume has been prepared for U.S. issuers. A second volume focuses on non-U.S. issuers (*Accessing the U.S. Capital Markets – Non-U.S. Issuers)*. A third volume focuses on securities products that are commonly offered in the U.S. capital markets (*Accessing the U.S. Capital Markets – Securities Products*).

For the definitions of certain terms used in this volume, please refer to the Glossary beginning on page 408.

Each volume of this edition of *Accessing the U.S. Capital Markets* appears on our web site at www.accessingsidley.com. Our web site also contains client alerts, memoranda and a wealth of other information helpful to issuers, investment banks and other participants in the U.S. capital markets.

This is the first edition of *Accessing the U.S. Capital Markets* that focuses on U.S. issuers.

We would like to thank our partners, associates and staff who contributed their time and effort in preparing this edition, particularly our 2012 summer associates, Jeffrey Arek, Kendall Bass, Emmanuel Charles II, Chris Choi, Dorothy Du, Thomas Farmar, Raymond Hedaya, Paul Jindra, Sonalee Joshi, Peter Kauffman, Clifford Laney, David Myers, Justin Platt and Jennifer Schaevitz.

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AN OVERVIEW OF U.S. SECURITIES REGULATORS AND LAWS

GENERAL 2
SECURITIES INDUSTRY REGULATORS 3
SECURITIES ACT OF 1933 6
SECURITIES EXCHANGE ACT OF 1934 7
SARBANES-OXLEY ACT OF 2002 11
SECURITIES OFFERING REFORM OF 2005 14
THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010 15
THE JUMPSTART OUR BUSINESS STARTUPS ACT OF 2012 18
TRUST INDENTURE ACT OF 1939 21
INVESTMENT COMPANY ACT OF 1940 22
"BLUE SKY" OR STATE SECURITIES LAWS 22

GENERAL

The federal securities laws and regulations apply to both U.S. issuers and non-U.S. issuers.[1] This volume focuses on the application of those laws to U.S. issuers. Accordingly, references to "issuers" in this volume generally refer only to U.S. issuers.

The federal securities laws expressly preserve the power of the states and certain territories of the United States to regulate securities activities within each state and territory, although federal legislation limits the scope of their authority and their ability to regulate many types of securities offerings. Every state and certain territories have adopted securities laws, commonly known as "blue sky" laws, which are administered by state or territorial officials.

Blue sky laws are discussed below under the heading "'Blue Sky' or State Securities Laws."

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[1] A "non-U.S. issuer" (the SEC's rules use the term "foreign issuer") is any issuer of securities that is a government (other than the government of the United States or any of its political subdivisions), a national of any country (other than the United States) or a corporation or other organization incorporated or organized under the laws of any such country or any of its political subdivisions. A "foreign private issuer" is defined under 1934 Act Rule 3b-4 and 1933 Act Rule 405 to be any non-U.S. issuer (other than a foreign governmental issuer) unless, as of the last business day of its most recently completed second fiscal quarter, (i) more than 50% of its outstanding voting securities are directly or indirectly held of record by residents of the United States and (ii) any one of the following exists: (A) the majority of its executive officers or directors are U.S. citizens or residents; (B) more than 50% of its assets are located in the United States; or (C) its business is administered principally in the United States. All other issuers are U.S. issuers.

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SECURITIES INDUSTRY REGULATORS

The Securities and Exchange Commission

The Securities and Exchange Commission (the "SEC") is the primary U.S. federal government agency responsible for administering the federal securities laws. Five principal statutes are the source of nearly all federal securities law: (i) the Securities Act of 1933 (the "1933 Act"); (ii) the Securities Exchange Act of 1934 (the "1934 Act"); (iii) the Trust Indenture Act of 1939 (the "1939 Act"); (iv) the Investment Company Act of 1940 (the "1940 Act"); and (v) the Investment Advisers Act of 1940. The SEC's responsibilities include:

- interpreting and enforcing the federal securities laws and regulations;
- issuing new rules and amending existing rules;
- overseeing the inspection of securities firms, investment advisers, securities exchanges and ratings agencies;
- overseeing private regulatory organizations in the securities, accounting and auditing fields; and
- coordinating securities regulation with federal, state and foreign authorities.

The SEC's web site is http://www.sec.gov. It includes the U.S. federal securities laws, the securities registration and issuer reporting forms, current and proposed rules and regulations and SEC staff interpretations and speeches, registrations and reporting obligations and information concerning the SEC's enforcement and regulatory proceedings. The SEC maintains on its web site the Electronic Data Gathering, Analysis, and Retrieval ("EDGAR") system, which contains issuer filings in connection with securities offerings, correspondence relating to the SEC staff's comments on issuer filings and other reports filed by public companies and mutual funds.

Chapter 3 (*The Securities Registration and Reporting Process*) and Chapter 4 (*Disclosure Requirements*) discuss these matters at greater length.

The Financial Industry Regulatory Authority

The Financial Industry Regulatory Authority ("FINRA") is an independent, not-for-profit membership corporation established in June 2007 through the consolidation of the National Association of Securities Dealers, Inc. (the "NASD") and the member regulation, enforcement and arbitration functions of the New York Stock Exchange (the "NYSE"). FINRA's activities include registering and educating securities industry participants, examining securities firms, writing rules, enforcing those rules and the federal securities laws, informing and educating the investing public, providing trade reporting and other industry utilities, and administering a dispute resolution forum for investors and registered

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firms. FINRA also performs market regulation under contract for the NYSE, the NYSE MKT,[2] NASDAQ, the International Securities Exchange and the Chicago Climate Exchange.

FINRA's web site is http://www.finra.org. It contains FINRA's rules for broker-dealer reporting and other requirements for securities offerings and trading, a list of broker-dealers that are registered with FINRA and information concerning FINRA's enforcement and regulatory proceedings.

The Public Company Accounting Oversight Board

The PCAOB is a not-for-profit corporation created by the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") to oversee the audits of public companies in order to protect investors and further the public interest in the preparation of informative, accurate and independent audit reports, through registration and inspection, standards-setting, enforcement and support functions. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to U.S. securities laws, to promote investor protection.

The PCAOB's web site is http://www.pcaobus.org. It contains the PCAOB's standards and rules and its interpretations of those standards and rules, proposed standards and rules, a list of registered accounting firms and information concerning the PCAOB's inspections and enforcement and regulatory proceedings.

U.S. Securities Exchanges

The NYSE, the NYSE MKT, NASDAQ and the other securities exchanges in the United States administer rules approved by the SEC that apply to securities and issuers of securities listed on the exchanges. Certain other rules and regulations applicable to members of the securities exchanges are administered by FINRA. Each exchange has a unique set of rules, although there are substantial similarities in the rules from exchange to exchange. The securities exchanges, which are private, for-profit corporations, are themselves regulated as "national securities exchanges" subject to registration under the 1934 Act and to the SEC's supervision.

The NYSE and NYSE MKT share a web site at http://www.nyse.com. NASDAQ's web site is http://www.nasdaq.com. Each site publishes the exchange's rules for listing and trading securities on the exchange, and the exchange's current interpretations of its rules, a list of issuers that are listed and dealers eligible to trade on the exchange. Information concerning the exchange's disciplinary and enforcement actions is also available on each

[2] Formerly known as the American Stock Exchange, or the Amex, the NYSE Alternext US and the NYSE Amex. Following the acquisition of the Amex by NYSE Euronext on October 1, 2008, the Amex was renamed NYSE Alternext US LLC and was subsequently renamed NYSE Amex LLC on March 18, 2009. NYSE Amex LLC was subsequently renamed NYSE MKT LLC on May 14, 2012. The NYSE MKT operates a marketplace for equities of small growth companies, and its associated options market continues to do business under the name NYSE Amex Options.

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site. Securities transactions at the NYSE occur on its trading floor and through its electronic platform, NYSE Arca.

The listing requirements of the NYSE, the NYSE MKT and NASDAQ are discussed in Chapter 6 (*Listing on U.S. Securities Exchanges*).

State and Territorial Securities Regulators

State and territorial securities regulators administer "blue sky" laws, rules and regulations that apply to securities offered or sold and broker-dealers and certain investment advisers that operate in their respective jurisdictions. The North American Securities Administrators Association ("NASAA") is an association of state and territorial securities regulators and Canadian and Mexican securities regulators. NASAA facilitates coordination of its members' securities, broker-dealer and investment adviser regulation.

NASAA's web site is http://www.nasaa.org. It provides links to the securities, broker-dealer and investment adviser laws and regulations of its members, and includes uniform forms and information on the current legislative, regulatory and enforcement activities.

Federal and State Bank and Thrift Regulators

The Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), the Office of the Comptroller of the Currency, an independent bureau of the Department of the Treasury (the "OCC"), the Federal Deposit Insurance Corporation (the "FDIC")[3] and various state bank regulatory agencies have the power to regulate certain securities offerings in the United States by U.S. banking and other financial institutions and U.S. branches and agencies of non-U.S. banks.

The Federal Reserve Board's web site is http://www.federalreserve.gov, the OCC's web site is http://www.occ.treas.gov and the FDIC's web site is http://www.fdic.gov. The Federal Reserve Board has not adopted regulations that apply to securities offerings by state banks that are members of the Federal Reserve System. Each of the OCC's and FDIC's web sites contains the agency's securities laws and regulations, securities and other forms, proposed rules and regulations and interpretations, filings with the regulator in connection with securities offerings and information concerning the regulator's enforcement and regulatory proceedings.

Securities regulation applicable to U.S. banking and U.S. branches and agencies of non-U.S. banks is discussed in Chapter 13 (*Bank Issuers*).

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[3] In accordance with Dodd-Frank, effective July 21, 2011, the powers, duties, and functions formerly performed by the Office of Thrift Supervision of the U.S. Department of Treasury, as to state savings associations, were transferred to the FDIC, as to federal savings associations, were transferred to the OCC, and as to savings and loan holding companies, were transferred to the Federal Reserve Board.

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The Commodity Futures Trading Commission

The Commodity Futures Trading Commission (the "CFTC") was created in 1974 as an independent federal agency with the mandate to regulate commodity futures and options markets in the United States. Under Dodd-Frank, the CFTC also has the power to regulate swaps markets and swap dealers.

The CFTC's web site is http://www.cftc.gov and contains, among other things, the Commodity Exchange Act and the rules adopted by the CFTC thereunder, the CFTC's current and proposed rules and current staff interpretations and information concerning enforcement and regulatory proceedings.

SECURITIES ACT OF 1933

Purpose

The two basic objectives of the 1933 Act are to require that investors receive financial and other significant information concerning securities being offered for public sale and to prohibit deceit, misrepresentations and other fraud in the sale of securities.

Registration

An issuer that wishes to sell its securities in the United States must register the offer and sale of those securities under the 1933 Act unless an explicit exemption is available for either the transaction or the securities sold. Most securities sold in the U.S. capital markets are either sold in transactions that are exempted from registration or are exempt securities. Chapter 8 (*Exempt Offerings and Securities*) discusses the exempt transactions and exempt securities that are often regarded as the most significant for U.S. issuers.

To register securities under the 1933 Act, an issuer must file with the SEC a disclosure document, known as a registration statement, which contains a prospectus describing the issuer's business, financial condition, results of operations and management, as well as the terms of the securities offered. The forms of registration statement available to most larger companies permit much of the required disclosure to be incorporated by reference from 1934 Act periodic reports. The "Plain English" rule requires the use of clear and simple writing principles in parts of the prospectus.[4]

Chapter 3 (*The Securities Registration and Reporting Process*) discusses the 1933 Act registration process in more detail, including the forms of 1933 Act registration statements available to U.S. issuers and the mechanics of the registration process.

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[4] See SEC Release No. 33-7497 (Jan. 28, 1998) (www.sec.gov/rules/final/33-7497.txt).

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Chapter 5 (*Shelf Registration*) discusses Rule 415 under the 1933 Act, which permits delayed or continuous offerings of securities. This rule allows issuers to register securities in advance of their offering; in effect, to register and place them "on the shelf" for later offering without any further SEC action.

Prospectuses

The prospectus filed with the SEC by an issuer in a registered securities offering must be delivered or made available to purchasers of the securities. In most exempt securities offerings it is customary to deliver a disclosure document. The amount of information in a disclosure document used for an offering that is not registered under the 1933 Act (typically called an "offering memorandum" or an "offering circular") depends primarily on the nature of the issuer, the type of securities being offered and the nature of the investors being solicited.

Chapter 4 (*Disclosure Requirements*) discusses the disclosure requirements for 1933 Act registration statements and prospectuses.

Trading Restrictions

Securities that have been registered under the 1933 Act (other than securities owned by affiliates) and securities that are themselves exempt from 1933 Act registration (*e.g.*, Section 3(a)(3) commercial paper and securities issued or guaranteed by banks or the U.S. government or its agencies) generally are not "restricted securities" and may be freely traded after their initial sale. Securities that are sold pursuant to transaction exemptions under the 1933 Act (*e.g.*, a private placement or a non-U.S. offering) may be subject to transfer restrictions. These transfer restrictions are discussed generally in Chapter 8 (*Exempt Offerings and Securities*), and specifically as to particular securities in *Accessing the U.S. Capital Markets – Securities Products*. Issuers and securities firms involved in the distribution of securities are also subject to trading restrictions until the completion of the distribution, as discussed in Chapter 1 (*The Offering Process*).

SECURITIES EXCHANGE ACT OF 1934

Purpose

The 1934 Act is the most comprehensive of the federal securities laws. It includes provisions applicable to public companies, U.S. securities exchanges, securities dealers, transfer agents and clearing agencies. In general, the 1934 Act is intended to ensure fair and orderly securities markets in the United States. The continuous reporting requirements of the 1934 Act applicable to public companies require reliable financial and other disclosures considered necessary for informed investment decisions concerning the securities of publicly-traded companies.

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Registration and Periodic Reporting

An issuer that lists its securities on a U.S. national securities exchange (such as the NYSE, the NYSE MKT or NASDAQ) must register the class of securities pursuant to the 1934 Act and SEC regulations. Registration under the 1934 Act imposes on an issuer a duty to file with the SEC annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. An issuer that registers securities for sale under the 1933 Act must also file reports under the 1934 Act for the fiscal year in which the securities were registered and for each subsequent fiscal year at the beginning of which such securities are held of record by 300 or more persons or, in the case of a bank or bank holding company, 1,200 or more persons. An issuer may otherwise be eligible to terminate 1934 Act registration and reporting, a subject treated in Chapter 17 (*De-registering Under the 1934 Act*). The information concerning issuers and their publicly-offered securities required by the 1934 Act is virtually the same as that required by the 1933 Act, which is called the SEC's "integrated disclosure" system.

An issuer that has total assets of more than $10 million and a class of equity security (other than an exempt security) held of record by either 500 persons who are not accredited investors under 1933 Act Regulation D or 2,000 persons in all is also required to file periodic reports under the 1934 Act. For bank and bank holding companies, the thresholds are total assets exceeding $10 million and a class of equity security held of record by 2,000 or more persons.

An issuer may voluntarily register a class of its equity securities under the 1934 Act and commence filing reports on Form 10-K, Form 10-Q and Form 8-K under the 1934 Act, even though it is not legally required to do so. Because of the SEC's integrated disclosure system, these filings may prepare the issuer for future public offerings in the United States. Furthermore, issuers that are required to timely file reports on Form 10-K, Form 10-Q and Form 8-K for one year may be eligible to use the abbreviated 1933 Act registration statement on Form S-3. Eligibility for Form S-3 filing is a practical necessity for shelf registration offerings, such as off-the-shelf debt and equity offerings and at-the-market equity offerings. Form S-3 is very convenient for continuous offerings such as medium-term note programs. Voluntary registration under the 1934 Act does subject the issuer to the requirements of Sarbanes-Oxley.

Chapter 3 (*The Securities Registration and Reporting Process*) discusses the 1934 Act registration and reporting process in more detail, including the 1934 Act registration statement and reporting forms. See also Chapter 7 (*Ongoing Reporting and Other Requirements*).

Chapter 4 (*Disclosure Requirements*) discusses the disclosure requirements for reports filed with the SEC under the 1934 Act.

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Proxy Statements

All proxy solicitations by a U.S. issuer with respect to securities registered under Section 12 of the 1934 Act are subject to the proxy rules in Regulation 14A under the 1934 Act. The proxy rules prevent management and others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitations. Accordingly, the rules specify certain information (including information regarding any proposals being put forth to the stockholders and extensive disclosures regarding compensation being paid to the issuer's named executive officers and directors) that must be provided in connection with any proxy solicitation by an issuer. These rules also cover the form of proxy card which is to be sent to stockholders.

A "proxy" is defined as every proxy, consent or authorization sought from a security holder, and may take the form of a failure to object to, or dissent from, a proposed action. A "solicitation" is generally defined to include (i) any request for a proxy whether or not accompanied by or included in a form of proxy, (ii) any request to execute or not to execute, or to revoke, a proxy or (iii) the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy. These definitions bring within the scope of the proxy rules all communications by directors and executive officers designed to influence the decisions of stockholders on proposals subject to their approval.

The proxy statement, form of proxy and other soliciting materials, in the form in which they are distributed to stockholders, must be filed with the SEC not later than the date on which such material is first sent or given to stockholders, which is customarily about thirty days prior to a meeting. In certain circumstances, a preliminary proxy statement, form of proxy and other soliciting material must be filed with the SEC at least ten days prior to the date the proxy is to be distributed to stockholders. If the proxy materials are selected for review by the SEC's staff, a longer delay in use is a practical necessity. See Chapter 4 (*Disclosure Requirements*) for a more detailed summary of the information required to be included in the proxy statement.

If proxies are not solicited by management for any meeting of stockholders, an information statement containing substantially the same information that would be included in a proxy statement must, nevertheless, be filed with the SEC and furnished to stockholders at least twenty days prior to the meeting.

Section 16 Reporting and Profit Recapture

Section 16 applies to every person who is the beneficial owner of more than 10% of any class of equity securities registered under Section 12 of the 1934 Act, and directors and certain officers of the issuer of such securities. Section 16 imposes a presumption that these persons have access to material, non-public information about the issuer. Section 16 requires public disclosure by these insiders of their transactions in the issuer's securities.

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Section 16 borrows the beneficial ownership test in Section 13(d) of the 1934 Act, and deems a person to be the beneficial owner of securities over which the person, directly or indirectly, has or shares voting and/or investment power, or could acquire the right to vote and/or invest within sixty days or less.

Section 16 also provides that the issuer, or any stockholder on behalf of the issuer, may recover any profits under Section 16(b) of the 1934 Act if an insider (including any 10% or more beneficial owner) enters into a purchase and sale, or sale and purchase, of the issuer's equity securities or security-based swap agreement "within any period of less than six months." These profits are commonly referred to as "short-swing" profits. The rules for calculating the profit that must be disgorged to the issuer by the insider generally are designed to extract the maximum liability from the insider, sometimes requiring disgorgement of funds even though the sequence of transactions as a whole was not profitable.

Tender Offers

Tender offers in general are regulated by the SEC pursuant to authority granted under Sections 13(e), 14(d), 14(e), and 14(f) of the 1934 Act. Regulation 14D and Regulation 14E contain the basic rules governing tender offers and exchange offers.

There is no statutory definition of a "tender offer" under the 1934 Act. Under court decisions, a series of factors are considered where the existence of a "tender offer" has been at issue. The matters conventionally considered are the following:

- whether there is an active and widespread solicitation of securityholders;
- whether the solicitation is for a substantial percentage of the issuer's securities;
- whether the offer is made at a premium over the prevailing market price;
- whether the terms of the offer are firm rather than negotiable;
- whether the offer is contingent upon the tender of a fixed minimum number of securities or subject to a fixed maximum number of securities to be purchased;
- whether the offer is open only for a limited period of time;
- whether securityholders are pressured to respond and sell into the offer; and
- whether public announcements of a purchase program precede or accompany a rapid accumulation of large amounts of the subject securities.[5]

[5] See *Wellman v. Dickinson*, 475 F.Supp. 783 (S.D.N.Y. 1979).

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While it is clear that not all the eight factors must be present for there to be a tender offer; it remains unclear precisely how many of the eight must be present for purchases to constitute a tender offer. However, any acquisition of a significant percentage of a class of securities over a short period from a large number of holders risk being considered a "tender offer."

A bidder must file with the SEC as soon as practicable on the day a tender offer is commenced, a tender offer statement on Schedule TO. The filed Schedule TO must disclose information required by items of Regulation M-A. It must later report any material change in the information in the schedule by promptly amending the schedule. A final amendment reporting the results of the tender offer is required at the conclusion of the transaction. Written pre-commencement communications, from and including the first public announcement of the issuer tender offer, must also be filed with the SEC as soon as practicable on the date of the communication. Tender offers may be disseminated to shareholders by publishing a summary advertisement containing specified information and providing information on how to obtain more detailed information regarding the tender offer as well as a letter of transmittal. Usually, however, a bidder will disseminate by publishing a summary advertisement and by mailing the offer to shareholders identified by shareholder lists and clearing agencies and their participants, in which case the issuer must contact brokers named in the clearing agency listing and to inquire about the number of beneficial owners for whom they hold shares.

See Chapter 15 (*Repurchasing, Exchanging and Amending an Issuer's Outstanding Securities*) and Chapter 18 (*Acquisitions of U.S. Entities*) for further discussions of the SEC's tender offer rules.

SARBANES-OXLEY ACT OF 2002

Purpose

Sarbanes-Oxley was designed largely to enhance investor protection through enhanced financial and other corporate disclosure, increased auditor independence and oversight, increased management accountability and increased penalties for wrongdoing. The enactment of Sarbanes-Oxley and the promulgation of regulations thereunder by the SEC resulted in significant changes in disclosure requirements for issuers.

Disclosure and Related Requirements

Sarbanes-Oxley requires a U.S. issuer that files annual reports with the SEC on Form 10-K to:

- file certifications of the chief executive officer (the "CEO") and chief financial officer (the "CFO") of the issuer regarding the accuracy of disclosure and the fair presentation of financial information in the issuer's annual or quarterly report;

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- file certifications of the CEO and the CFO regarding management's assessment of internal control over financial reporting and the effectiveness of the issuer's internal control over financial reporting as of the end of its most recent fiscal year, together with the opinion of the issuer's external auditors on the effectiveness of the issuer's internal control;[6]

- disclose whether at least one audit committee member is an "audit committee financial expert," as defined by SEC rules adopted pursuant to Sarbanes-Oxley, or if not, why not;

- disclose whether it has adopted a code of ethics for certain of its executive officers or, if not, why not;

- disclose critical accounting estimates used in applying the issuer's accounting policies;

- disclose any material off-balance sheet arrangements and contractual obligations; and

- reconcile to generally accepted accounting principles ("GAAP") any non-GAAP financial measures in an issuer's oral or written public statements (including press releases and reports filed with the SEC).

For more information on the foregoing requirements see Chapter 3 (*The Securities Registration and Reporting Process*) and Chapter 4 (*Disclosure Requirements*).

Audit, Auditor and Audit Committee Requirements

Pursuant to Sarbanes-Oxley, the SEC has adopted standards for an issuer listed on the NYSE, the NYSE MKT and NASDAQ (but not for unlisted 1934 Act reporting issuers) relating to:

- the composition and role of audit committees;

- audit committee pre-approvals of auditor services;

- prohibitions and limitations on independent accountants performing specified non-audit services;

- rotation of audit partners;

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[6] Sarbanes-Oxley was amended by the Dodd-Frank Act and the JOBS Act to exempt non-accelerated issuers and emerging growth companies, respectively, from the external audit of internal control requirement.

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- records retention by the accounting firm;
- limitations on the issuer's employment of a former member of the audit engagement team; and
- prohibitions on an issuer's improper influence on the conduct of audits.

Under these rules, the NYSE, the NYSE MKT and NASDAQ must prohibit the listing of an issuer's securities if the issuer is not in compliance with the audit, auditor and audit committee requirements.

For further information on the foregoing requirements, see Chapter 6 (*Listing on U.S. Securities Exchanges*).

Other Requirements

Other Sarbanes-Oxley provisions relate to:

- requirements for attorneys "appearing and practicing" (as defined by SEC rules adopted pursuant to Sarbanes-Oxley) before the SEC to report a material violation of U.S. law by the issuer to the issuer's chief executive or chief legal officer, or other specified persons or groups, and to determine whether an appropriate response has been made;
- prohibitions on issuer loans to directors and executive officers;
- forfeiture of bonuses (and any realized profits from the sale of the issuer's securities) by CEOs and CFOs following a restatement of the issuer's financial statements due to material non-compliance by the issuer, as a result of misconduct, with any financial reporting requirement of the U.S. securities laws;
- whistleblower protections for employees; and
- prohibitions on insider trading during blackout periods under sponsored individual account plans.

Application

Sarbanes-Oxley applies to "issuers," which are generally companies required to file periodic reports with the SEC under Section 13(a) or 15(d) of the 1934 Act. A company that has filed a registration statement under the 1933 Act for an initial public offering or "IPO" is also an "issuer" for purposes of Sarbanes-Oxley, although almost none of the provisions of Sarbanes-Oxley apply to such a company unless and until the registration statement has become effective and the company has become subject to the SEC's reporting requirements, the exception being the prohibition against issuer loans to directors and executive officers.

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For a summary of the status of rule making under Sarbanes-Oxley, see http://www.sec.gov/spotlight/sarbanes-oxley.htm.

SECURITIES OFFERING REFORM OF 2005

Securities Offering Reform, a comprehensive set of rule and form changes adopted by the SEC in 2005, effected many significant changes to the registration process, including the following:

- any "well-known seasoned issuer" or "WKSI" (but not underwriters or dealers acting for it) may make oral or written offers of securities for capital raising transactions at any time without violating the 1933 Act's otherwise general prohibition against offering securities before the filing of a 1933 Act registration statement;
- any other eligible issuer may use a free writing prospectus after the filing of a 1933 Act registration statement, subject to the filing, delivery, notice and record keeping conditions in Rule 433;
- WKSIs may file automatic shelf registration statements, which:
  - are effective upon filing;
  - are not subject to pre-effective review by the staff of the SEC;
  - are required to contain minimal content beyond the business and other information incorporated by reference from the issuer's 1934 Act reports;
  - can be amended without the review of the staff of the SEC to include any type of securities and to add eligible subsidiaries of the WKSI as additional issuers; and
  - are eligible either for upfront or "pay as you go" filing fee arrangements;
- in the case of shelf registration statements for all eligible issuers,
  - there is no limit on the amount of the securities that may be registered on a shelf registration statement, except for certain offerings by U.S. issuers ineligible to use Form S-3, which are limited to the amount the issuer reasonably believes will be sold within two years of the effective date;
  - shelf registration statements for delayed primary offerings, mortgage-backed securities and certain continuous offerings are subject to a conditionally extendible three-year limitation; and
  - securities can be sold off the shelf immediately upon effectiveness;

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- a final prospectus generally no longer needs to be delivered to investors provided the final prospectus is filed with the SEC.

THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010

Purpose

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") was enacted primarily to promote financial stability by improving accountability and transparency in the U.S. financial system and to protect consumers from perceived abuses in financial services. Dodd-Frank includes provisions that apply to public companies generally, regulating executive compensation and corporate governance practices and prescribing disclosure requirements for certain industries.

Compensation, Compensation Adviser and Compensation Committee Requirements

Dodd-Frank

- requires issuers subject to the SEC's compensation disclosure requirements to include a separate advisory "say-on-pay" vote in proxy statements at least once every three years,[7] by which stockholders may approve the overall compensation of named executive officers;
- requires disclosure and an advisory vote on golden parachute arrangements or understandings if stockholders are voting on an acquisition, merger or similar extraordinary transaction and the golden parachutes were not previously part of an earlier say-on-pay vote; and
- requires the SEC to adopt rules requiring disclosure on the relationship between executive compensation actually paid and the issuer's financial performance as well as the ratio of the CEO's compensation to the median compensation of other employees of the issuer.[8]

In January 2011, the SEC adopted rules, effective April 4, 2011, to implement the provisions relating to shareholder approval of executive compensation and golden parachute arrangements.

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[7] Dodd-Frank also requires that stockholders be given an advisory vote whether to hold the say-on-pay vote every year, every two years or every three years.

[8] The SEC has yet to propose rules implementing this provision.

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Pursuant to Dodd-Frank, the SEC has adopted standards for issuers listed on the NYSE, the NYSE MKT, NASDAQ and any other national securities exchange (but not for unlisted 1934 Act reporting issuers) requiring:

- independence standards for members of compensation committees;
- authority for compensation committees to retain and be responsible for compensation and oversight of compensation consultants, legal counsel and other advisers (collectively "compensation advisers");
- appropriate issuer funding for compensation of its compensation advisers;
- consideration by compensation committees of certain factors affecting the independence of compensation advisers before selecting such advisers; and
- disclosure in proxy materials describing any conflict of interest raised by the work of a compensation consultant and how any such conflict was or is being addressed.

Under these rules, the NYSE, NYSE MKT, NASDAQ and any other national securities exchange must prohibit the listing of an issuer's equity securities if the issuer is not in compliance with the compensation committee and compensation adviser standards.

For more information about the foregoing, see Chapter 6 (*Listing on U.S. Securities Exchanges*).

Corporate Governance

Dodd-Frank:

- authorizes the SEC to adopt rules giving stockholders access to issuer's proxy solicitation materials to nominate directors;[9] and
- requires national securities exchanges to prohibit brokers from voting proxies on election of directors (except uncontested elections of investment companies), executive compensation and other significant matters as determined by the SEC without specific beneficial owner instructions.

Specialized Corporate Disclosure

Dodd-Frank also calls for disclosure for issuers in certain industries. These require:

[9] On August 25, 2010, the SEC adopted rules under Rule 14a-11 of the 1934 Act to implement this provision. However, in *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011), the U.S. Court of Appeals vacated the rule. The SEC did not appeal and has not yet taken any other action on the matter.

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- the adoption of SEC rules prescribing disclosure of the use of certain minerals sourced from the Democratic Republic of Congo and adjoining countries;[10]

- operators of coal and other mines to include in each periodic report certain items relating to mine-safety history, and to file a Form 8-K report disclosing receipt of certain safety-related notices from regulators;[11] and

- the adoption of SEC rules directing issuers engaged in commercial development of oil, natural gas or minerals to disclose in their annual reports certain payments made to the U.S. or a foreign government.[12]

Credit Ratings

In light of Section 939A of Dodd-Frank intended to reduce reliance on the credit ratings of NRSROs, the SEC has adopted rules that:

- remove a transaction standard under Form S-3 permitting registration of non-convertible securities carrying an investment grade rating and substitute a standard based on the issuance for cash of at least $1 billion in such non-convertible securities in registered offerings over the prior three years;

- require the determination whether a broker's or dealer's research report is an offer of securities by reference to the above test under a 1933 Act safe-harbor rule; and

- disallow the inclusion of credit ratings in certain communications deemed under Rule 134 of the 1933 Act not to be a prospectus.

Other Requirements

Other Dodd-Frank provisions:

- mandate the exclusion of the value of the primary residence of a person in determining the net worth of such person or joint net worth with the spouse of such person for purposes of the "accredited investor" definition under the 1933 Act rules;[13]

- exempt non-accelerated issuers from Sarbanes-Oxley's external audit of internal control requirement;

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[10] See SEC Release No. 34-67717 (Aug. 22, 2012) (http://www.sec.gov/rules/final/2012/34-67717.pdf).

[11] See SEC Release No. 33-9286 (Dec. 21, 2011) (http://www.sec.gov/rules/final/2011/33-9286.pdf).

[12] See SEC Release No. 34-67717 (Aug. 22, 2012) (http://www.sec.gov/rules/final/2012/34-67717.pdf).

[13] See SEC Release No. 33-9287 (Dec. 21, 2011) (http://www.sec.gov/rules/final/2011/33-9287.pdf).

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- require the SEC to adopt rules mandating disclosure in an issuer's proxy statement of the issuer's policy on purchase by directors or employees of instruments for hedging positions in any equity security of the issuer;[14] and

- require the SEC to adopt rules regarding the adoption by exchange-listed issuers of a policy covering the clawback of incentive compensation paid to all executive officers in the event of an accounting restatement due to material noncompliance with financial reporting requirements.[15]

For a summary of the status of rule making under Dodd-Frank, see http://sec.gov/spotlight/dodd-frank.shtml.

THE JUMPSTART OUR BUSINESS STARTUPS ACT OF 2012

Purpose

Substantial changes were made to the 1933 Act and 1934 Act by the Jumpstart Our Business Startups Act (the "JOBS Act"). The JOBS Act liberalizes communication practices allowed under the 1933 Act in both registered and exempt offerings. Reduced disclosure requirements and certain other benefits under both the 1933 Act and the 1934 Act will be available for smaller companies. The JOBS Act also substantially increases the number of record holders a private company may have before it is required to register its equity securities under the 1934 Act.

Relief for Emerging Growth Companies

Title I of the JOBS Act creates a new category of issuers known as "emerging growth companies" ("EGCs"), defined as companies domestic or foreign with less than $1 billion of "total annual gross revenues" for their most recent fiscal year, but excluding companies that sold stock to the public on or before December 8, 2011. EGCs are exempted from certain disclosure requirements for both their registration statements and periodic reports and are afforded special privileges in connection with their public offerings of securities. EGC status is available for up to five years following an issuer's IPO. EGCs are:

- exempt from the Dodd-Frank Act's say-on-pay and golden parachute provisions and from certain compensation disclosure requirements (including the CEO compensation comparison requirements and the pay-for-performance disclosures);

- required to present only two years of audited financial statements in an IPO registration statement;

[14] The SEC has yet to propose rules implementing this provision.

[15] The SEC has yet to propose rules implementing this provision.

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- not required to present selected financial data in any registration statement for periods preceding the earliest audited period in its IPO registration statement;
- grandfathered from compliance with new or revised financial accounting or auditing standards;
- exempt from the Sarbanes-Oxley auditor attestation requirement relating to internal control over financial reporting;
- permitted to make direct or indirect pre-filing "test-the-waters" communications with qualified institutional buyers ("QIBs") or institutional accredited investors; and
- permitted to submit draft registration statements for review by the SEC staff on a confidential non-public basis, subject to the requirement of a public filing not later than twenty-one days prior to the first road show for the offering.

Broker-dealer research in connection with a public equity offering by an EGC is deemed not to be an offer of securities. The JOBS Act forbids the SEC and FINRA from restricting who can arrange for communications between a securities analyst and an investor or restricting a securities analyst from participating in meetings with colleagues (including investment bankers) and the management of an EGC. The SEC and FINRA are also forbidden from maintaining any rule restricting the release of analyst research reports or public appearances following an EGC's IPO or following the expiration date of a lock-up.

General Solicitation

Title II of the JOBS Act directs the SEC to amend rules under the 1933 Act to permit general solicitation or general advertising in connection with certain unregistered securities offerings. The law directs adoption of an amendment to Rule 506 under Regulation D, the safe-harbor version of the Section 4(a)(2) exemption, to permit such solicitation and advertising, provided that all sales are only to accredited investors. Similar revisions are required for Rule 144A. The relief from the general solicitation prohibition does not apply to Section 4(a)(2) offerings made outside Rule 506 or to private placements by persons other than the issuer. The SEC has yet to adopt these rules. See also Chapter 8 (*Exempt Offerings and Securities*).

The New Crowdfunding Exemption

"Crowdfunding" describes seeking funds over the Internet, often through social media. Title III of the JOBS Act creates an exemption from registration intended to allow securities sales through crowdfunding. New Section 4(a)(6) of the 1933 Act will allow certain issuers to make unregistered offers and sales of up to $1 million of their securities in

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any twelve-month period, subject to limits on the amount that may be sold to a single investor and other conditions to be established by SEC rulemaking.[16]

Expanded Small Public Offering Exemption

Regulation A is an exemption from registration for small public offerings under Section 3(b) of the 1933 Act. Because of a low limit on offering size ($5 million since 1992), the use of Regulation A has declined in recent years. Title IV of the JOBS Act raises the maximum amount that may be sold in reliance on Section 3(b) to $50 million in any twelve-month period. The statute also directs the SEC to adopt regulations to allow public offerings up to the new maximum. Companies relying on the new exemption will be required to file financial statements annually with the SEC and may be subject to such additional disclosure requirements as the SEC may require in periodic reports outside the 1934 Act.[17]

1934 Act Section 12(g) Registration

Effective immediately, Title V of the JOBS Act significantly raised the size of the record-holder population needed to bring the Section 12(g) registration requirement (and SEC reporting requirement) under the 1934 Act into force. The JOBS Act increases the record-holder test from 500 persons to 2,000 persons or to 500 persons who are not accredited investors. The issuer's employees are excluded from the calculation if they acquire stock pursuant to an employee compensation plan in transactions exempted under the 1933 Act.

Under Title VI of the JOBS Act, banks and bank holding companies become subject to the Section 12(g) registration requirement only at the 2,000 holder-of-record threshold, and they may terminate registration if the number of record holders declines to fewer than 1,200 persons. (Companies other than banks and bank holding companies remain subject to the current 300-record-holder test for termination of registration.). Because the SEC is directed to issue final regulations within a year of enactment to implement the amendments for banks and bank holding companies, it is not clear when they will take effect.[18]

Status of JOBS Act Rule Making

For a summary the status of rule making under the JOBS Act, see http://sec.gov/spotlight/jobs-act.shtml.

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[16] The SEC has yet to propose rules implementing this provision.

[17] The SEC has yet to propose rules implementing this provision.

[18] On April 11, 2012, the SEC began accepting public comment prior to JOBS Act rulemaking. See http://www.sec.gov/news/press/2012/2012-60.htm)

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TRUST INDENTURE ACT OF 1939

Purpose

The purpose of the 1939 Act is to protect investors in debt securities registered under the 1933 Act by mandating certain qualifications of indenture trustees and certain terms and conditions in qualified indentures relating to those debt securities. These indenture terms protect the rights of indenture securityholders by imposing certain duties and rights on the indenture trustee and the obligor and by prohibiting provisions inconsistent with the statutory standards. Issuers of certain other obligations, such as guarantees and trust preferred securities, must also qualify governing instruments for such obligations under the 1939 Act.

For a useful annotation of the Trust Indenture Act prepared by the Committee on Trust Indenture and Indenture Trustees of the ABA's Section of Business Law, see http://www.americanbar.org/tools/digitalassetabstract.html/content/dam/aba/publications/business_lawyer/2012_67_4/tbl_2012_v67_n4_03_r_tia.pdf (log-in required).

Qualification

Any issuer that proposes to sell its debt securities in the United States must issue those debt securities pursuant to a trust indenture qualified under the 1939 Act unless an exemption from qualification is available. Generally, if an offering or a debt security is exempt from the registration requirements of the 1933 Act, such as Rule 144A offerings and private placements, the issuer is not required to qualify a trust indenture pursuant to the 1939 Act.

Trust indentures that are qualified under the 1939 Act are largely standardized except for covenants and events of default, which vary depending upon the nature of the issuer (particularly its credit rating) and the type of security to be issued. Where qualification of a trust indenture is not required, issuers may issue debt securities pursuant to an agreement that does not impose on the issuing agent fiduciary duties to the securityholders equivalent to those imposed on a trustee under a trust indenture. These agreements, known as "issuing and paying agent agreements" and "fiscal agency agreements," are also largely standardized. An issuing and paying agent agreement or a fiscal agency agreement may result in lower administrative costs for the issuer because an issuing and paying agent which is not subject to a fiduciary standard of conduct charges less for its services than an indenture trustee charges. Certain issuers of privately-placed longer-term debt, however, may use a trust indenture because they expect to issue 1933 Act-registered debt securities in the future or because they have been advised by securities firms that the fiduciary role of the trustee improves the marketability of debt securities issued under a trust indenture.[19]

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[19] Under a trust indenture, the trustee owes certain fiduciary obligations to and in certain cases is permitted or required to take actions on behalf of securityholders, whereas a fiscal agent or issuing and paying agent generally acts only as the agent of the issuer and owes no fiduciary duties to securityholders.

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INVESTMENT COMPANY ACT OF 1940

Purpose

The 1940 Act is designed to regulate investment vehicles offered to U.S. investors that fall within the definition of "investment company" under the 1940 Act. "Investment company" is broadly defined in Section 3(a) of the 1940 Act to include any issuer that is (i) engaged primarily in the business of investing, reinvesting or trading in securities, (ii) engaged in that business (whether or not primarily so) or the holding or owning of securities and owns or proposes to acquire investment securities[20] (exclusive of securities issued or guaranteed by the U.S. federal government and cash items) having a value exceeding 40% of the value of the issuer's total assets on an unconsolidated basis or (iii) engaged in the business of issuing face-amount certificates of the installment type.

Registration

Because the 1940 Act embodies a broad regulatory scheme intended primarily for mutual funds, unit investment trusts and closed-end investment companies, its requirements are not consistent with the conduct of normal business operations in other industries. Accordingly, it is important that issuers avoid having to register under the 1940 Act to the extent allowed by the statute. Most issuers that are operating companies, banks or insurance companies will not be subject to the 1940 Act either because they do not fall within the definition of an investment company or because they qualify for an exemption. However, because the definition of security under the 1940 Act is extremely broad, certain issuers (such as leasing companies and companies with significant interests in less than majority-owned affiliates) may have more difficulty in qualifying for an exemption under the 1940 Act. Chapter 9 (*1940 Act-Exempt Issuers*) discusses certain exemptions from the 1940 Act. Appendix B (*Determining whether an Issuer is a Prima Facie Investment Company or Exempt Pursuant to Rule 3a-1 under the Investment Company Act of 1940*) contains a discussion of how to determine whether an issuer is a *prima facie* investment company or exempt pursuant to Rule 3a-1 under the 1940 Act.

"BLUE SKY" OR STATE SECURITIES LAWS

Purpose

Each state has "blue sky" or securities laws, which frequently regulate both offerings of securities and the activities of broker-dealers. Unlike federal laws and regulations, which

[20] The term "investment securities" is defined in Section 3(a)(2) of the 1940 Act to include all securities except (1) securities issued or guaranteed by the U.S. federal government, (2) securities issued by employees' securities companies and (3) securities issued by majority-owned subsidiaries of the owner (a) which are not investment companies and (b) which are not relying on the exception from the definition of "investment company" found in paragraph (1) or (7) of Section 3(c) of the 1940 Act.

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tend to focus on disclosure requirements, blue sky laws often focus on protecting investors through an examination of the merits of an offering.

Federal Preemption

By enacting The National Securities Markets Improvement Act of 1996 ("NSMIA"), Congress intended to promote efficiency in the regulation of the U.S. capital markets. NSMIA preempts certain aspects of state securities laws, eliminates much state regulation of national securities offerings and streamlines state regulation of broker-dealers. The states retain authority to regulate small, regional or intra-state securities offerings, and to bring actions to enforce state laws and regulations prohibiting fraud and deceit, including broker-dealer sales practice abuses.

NSMIA preempts state authority to require registration or qualification of offerings by registered investment companies, companies with securities listed on a principal securities exchange and issuers selling securities privately pursuant to Rule 506 under the 1933 Act. NSMIA preserves, however, the states' ability to require notice filings and assess fees in connection with certain of such offerings. NSMIA also preempts state regulation of broker-dealers with respect to capital, custody, margin, financial responsibility, record keeping, bonding and financial or operational reporting that differs from, or are in addition to, federal requirements.

Registration

Subject to the limitations imposed by NSMIA, securities offerings must be registered in any state where the securities will be offered or sold unless there is an applicable exemption. The most useful securities exemption introduced by NSMIA applies to companies listed on the NYSE, the NYSE MKT or NASDAQ. The exemption covers not only the listed security itself, but also extends to securities of the same issuer that are of senior, or substantially equal, rank to securities which are so listed. This means, for example, that if an issuer has listed its common stock on the NYSE, all offerings of its common stock, preferred stock and debt would be eligible for the exemption. Therefore, qualifying issues of securities by issuers under the blue sky laws can be relatively simple, and involve relatively little expense in state filing fees, if the issuer qualifies for the listing exemption. The blue sky process is typically handled by counsel for the underwriters or the selling agents.

Generally, an offer and sale of securities made in violation of a state's securities registration requirement under its blue sky law results in rescission liability or damages against the "seller" of the securities, as well as any "controlling" person thereof, and may also result in the imposition of civil and criminal fines and penalties. Most states' blue sky

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laws are modeled upon some version of a Uniform Securities Act promulgated by the NASAA, although there are notable exceptions.[21]

All states provide some kind of transaction exemption for offers and sales to broker-dealers and institutional investors, although in certain states the classes of investors are limited. Such investors typically are banks, savings institutions, trust companies, insurance companies, investment companies, pension or profit-sharing trusts and "other financial institutions or institutional buyers." This blue sky exemption is commonly available for offerings that are marketed exclusively to institutional investors, such as commercial paper, certain medium-term note programs and Rule 144A offerings.

Special state laws may be applicable if the issuer is funding certain types of businesses, such as real estate or gambling.

Certain states have separate insurance securities laws that regulate the offer and sale of securities by insurance companies, insurance holding companies and other issuers, domestic or foreign, that will use the proceeds from the offering to finance the operations of an insurance company (for example, an offering by a non-insurer/sister affiliate or a special-purpose vehicle set up offshore for tax or off-balance sheet financing purposes). Under certain states' insurance securities laws, an offeror is required to secure a "solicitation permit" from the applicable states' insurance commissioner prior to the commencement of "offers" therein (such as the solicitation of indications of interest and/or the circulation of offering materials).[22]

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[21] For example, the blue sky laws of California, Florida, Illinois, New York, Ohio and Texas do not follow the Uniform Securities Act.

[22] The New York state blue sky law generally requires the registration of public offerings involving participation interests or investments in real estate, including mortgages or leases, subject to certain exemptions. The New York Attorney General's Office, which oversees the New York state blue sky law, generally takes the position, for example, that the securities issued by hotel operators are "real estate" because the hotel operator generates revenues from the "renting" of hotel rooms – a "real estate" activity. A separate filing could be required in New York for this type of offering, although filings should not be required for Section 4(a)(2) or Rule 506 offerings or Rule 144A offerings.

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SECTION I. PRELIMINARY MATTERS

The process of offering and selling securities in the U.S. capital markets, and the preparation required to do so, varies according to the issuer involved, the structure of the transaction, the type of security or securities being offered and the requirements of the applicable investors. For instance, the offering process for privately-placed securities will differ from that for publicly-offered securities; negotiated private placements will proceed differently from so-called “take it or leave it” private placements or Rule 144A offerings; 1933 Act-registered public offerings will proceed differently from 1933 Act-exempt offerings; 1933 Act-registered public offerings for EGCs will proceed differently from 1933 Act-registered public offerings for other issuers; whether the securities are being offered through an existing securities facility, such as a medium-term note program or shelf registration, will also affect the offering process. Equity offerings differ from debt offerings in certain respects. The approach for securities that are to be sold only in the U.S. capital markets may differ from that employed for securities that are to be sold internationally as well.

The purpose of Section I is to address some key aspects of offering and selling securities in the U.S. capital markets.

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CHAPTER 1

THE OFFERING PROCESS

GENERAL 26
INITIAL CONSIDERATIONS 27
OVERVIEW OF THE U.S. OFFERING PROCESS 30
ISSUER CLASSES 34
OFFERING DOCUMENTS 38
DUE DILIGENCE 46
LIMITATIONS ON PUBLICITY 52
RESEARCH REPORTS 56
ROADSHOWS 58
STABILIZATION AND REGULATION M 60

GENERAL

An issuer considering accessing the U.S. capital markets typically engages one or more securities firms with a significant presence in the U.S. capital markets to "lead" or "arrange" the transaction. We sometimes refer to these firms as "underwriters" or "agents," depending upon the nature of their commitment. Both the issuer and the securities firms usually engage experienced law firms such as Sidley to assist in documenting the transaction and ensuring it complies with applicable laws, regulations and practices. The offering process itself differs significantly depending on the issuer involved, the type of securities being offered, the manner of offering and the markets into which the securities are being offered and sold. For example, the time and expense involved in offerings of commercial paper, bank certificates of deposit or extendible notes are typically significantly less than the time and expense involved in a 1933 Act-registered and NYSE- or NASDAQ-listed initial public offering of common stock.

After discussing some initial considerations an issuer confronts prior to a securities offering, this chapter provides an overview of the mechanics of the U.S. offering process and SEC issuer categories. This chapter then focuses on the preparation and use of offering documents, the purposes and mechanics of due diligence, the limitations on publicity during the offering process, the permissibility of certain types of securities analyst research reports during the offering process, certain considerations relating to roadshows and the rules for stabilizing the price of offered securities during the offering. In addition, subsequent chapters and the other *Accessing the U.S. Capital Markets* volumes address the offering process in particular circumstances, including those that focus on the following:

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- the manner in which an offering is conducted;[23]
- the offering process for particular types of securities;[24] and
- the offering process for issuers in particular industries.[25]

INITIAL CONSIDERATIONS

In addition to the issues discussed below, which apply generally to all issuers, in Chapter 2 (*Pre-Offering Matters*) we address certain pre-offering matters that we have found to be particularly relevant to issuers that are accessing the capital markets for the first time.

Stand-Alone Offering or Program

An important decision that an issuer has to make prior to offering securities is whether to offer those securities in a stand-alone transaction or establish a program or file a shelf registration statement through which the issuer can continuously or from time to time offer and sell securities. A program or shelf registration statement provides an issuer with the ability to access the capital markets opportunistically and generally reduces the overall cost of multiple offerings, but comes with the cost of regularly maintaining and updating the disclosure and other documentation relating to the program or shelf.

In certain cases, a stand-alone offering is the only option. For example, an issuer offering its equity securities for the first time in a 1933 Act-registered public offering must make a stand-alone offering, as it is not permitted by the SEC's rules to file a shelf registration statement.[26] In the case of some securities, such as high-yield debt securities, it may be legally permissible to establish a program but, for a variety of reasons, those securities are generally offered solely on a stand-alone basis.[27] Also, an issuer may intend to access the capital markets so infrequently or irregularly that the maintenance costs of a program or shelf are not commercially justifiable.

Some types of securities, such as medium-term notes and commercial paper,[28] are only offered in the capital markets pursuant to programs. Programs registered under the

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[23] See Chapter 3 (*The Securities Registration and Reporting Process*), Chapter 5 (*Shelf Registration*) and Chapter 8 (*Exempt Offerings and Securities*).

[24] See *Accessing the U.S. Capital Markets – Securities Products*.

[25] See Chapter 10 (*Finance Subsidiaries*), Chapter 11 (*REITs*), Chapter 13 (*Bank Issuers*) and Chapter 14 (*Insurance Company Issuers*).

[26] If the issuer is an EGC, it may have options to reduce the burdens of registration and reporting as described in Chapter 3 (*The Securities Registration and Reporting Process*) and Chapter 4 (*Disclosure Requirements*).

[27] See *Accessing the U.S. Capital Markets – Securities Products*.

[28] See *Accessing the U.S. Capital Markets – Securities Products*.

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1933 Act are more convenient for some issuers than others. As discussed in Chapter 5 (*Shelf Registration*), an issuer that is a WKSI has the ability to file a shelf registration statement covering a broad range of securities that becomes effective automatically upon filing with the SEC. WKSIs enjoy certain other benefits that are not available to other types of issuers.

1933 Act-Registered or Not

Another decision that faces an issuer seeking to offer securities in the capital markets is whether to register the offering under the 1933 Act[29] or to rely on a transactional exemption from the 1933 Act to offer the securities.[30] This decision is not an issue for securities that are themselves exempt from the registration requirements of the 1933 Act, regardless of the transaction by which they are offered. These include, among others, securities issued by U.S. banks exempted pursuant to Section 3(a)(2) and commercial paper exempted by Section 3(a)(3).[31]

The decision to register securities under the 1933 Act depends on many factors, particularly whether the benefits to the issuer of the broader distribution available in connection with a 1933 Act-registered offering outweigh the related costs to the issuer. These include the cost of compliance with Sarbanes-Oxley, Dodd-Frank, the Foreign Corrupt Practices Act of 1977 (the "FCPA")[32] and the SEC's related rules.[33]

The provisions of Sarbanes-Oxley, Dodd-Frank and the FCPA generally apply to issuers that have securities listed on a U.S. securities exchange under Section 12 of the 1934 Act or are required to file reports under Section 15(d) of the 1934 Act. The SEC staff takes the view that certain provisions of Sarbanes-Oxley apply to voluntary filers under Section 15(d) of the 1934 Act. The provisions of Sarbanes-Oxley, Dodd-Frank and the FCPA do not apply to an issuer that has only sold securities pursuant to Rule 144A, although they would become applicable if the financing is followed by a registered exchange offer or a registered resale shelf or the issuer is or, as a result of the transaction, becomes subject to the reporting obligations under the 1934 Act.[34] As discussed in Chapter 3 (*The Securities Registration and Reporting Process*), the JOBS Act provides certain relief from various reporting and Sarbanes-Oxley requirements for issuers that qualify as EGCs.

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[29] See Chapter 3 (*The Securities Registration and Reporting Process*) and Chapter 5 (*Shelf Registration*).

[30] See Chapter 8 (*Exempt Offerings and Securities*).

[31] *Id.*

[32] Sections 13(b)(2) and 30A of the 1934 Act.

[33] Chapter 4 (*Disclosure Requirements*) describes an issuer's disclosure obligations under the 1933 Act and the 1934 Act. Chapter 7 (*Ongoing Reporting and Other Requirements*) describes an issuer's 1934 Act reporting obligations. Chapter 17 (*De-Registering Under the 1934 Act*) describes the circumstances under which an issuer may terminate its 1934 Act reporting (including Sarbanes-Oxley requirements) and other obligations.

[34] See Chapter 7 (*Ongoing Reporting and Other Requirements*).

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Many of the reporting requirements of the 1934 Act and other applicable laws need to be satisfied at the time of the offering and sale of securities in the U.S. capital markets or at the time of listing on a U.S. securities exchange, as well as on an ongoing basis.

U.S. Only or International Offering

Whether the securities are offered solely in the United States or in other jurisdictions as well will have an impact on the U.S. offering process. Some securities that are offered and sold in the U.S. capital markets, such as commercial paper and extendible notes, are directed primarily toward the U.S. capital markets and rarely include an international or Regulation S tranche. Others, such as offerings of longer-term fixed-income securities and equity securities, have varying degrees of international participation; in certain of these types of offerings, the U.S. capital markets are not the sole or primary market for the securities being offered.

Where the U.S. capital markets are in fact the sole or primary market for a securities offering, as in the case of an IPO of NYSE- or NASDAQ-listed common stock with limited sales to investors outside the United States, the regulations and practices of the U.S. offering process will prevail. However, where the U.S. capital markets are one of several primary markets in a global offering, as in an IPO of common stock that is listed on the NYSE or NASDAQ, the Hong Kong Stock Exchange, the Tokyo Stock Exchange and the London Stock Exchange, the standard mechanics of the U.S. offering process are more likely to be modified to follow or accommodate the mechanics of the offering process in each other applicable jurisdiction. In any such case, however, it is important to ensure that the requirements for a U.S. offering are nevertheless satisfied.

In a global offering, some of the securities may be designated for sale in a public offering in the United States and registered under the 1933 Act. In this situation, a consideration for the issuer is the extent to which securities sold outside the United States should be registered under the 1933 Act. The three options are:

(1) register only those securities allotted to the U.S. underwriters for sale in the United States and rely on Regulation S for the securities sold in offshore transactions outside the United States to non-U.S. persons;

(2) register a certain amount of additional securities to provide for the possibility of additional securities flowing back into the United States; or

(3) register the entire offering.

The substantive reason to register securities sold outside the United States in a global financing is that any such securities resold into the United States would be required to be registered unless sold in an exempt transaction. Because securities dealers cannot rely on the trading exemption provided by Section 4(a)(3) of the 1933 Act any sooner than twenty-five days after an IPO, any transactions they would make in such resold securities would be violations of the 1933 Act. Consequently, the most conservative approach is to register the

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entire international offering. If this is done, there is no risk of unregistered securities being sold into the U.S. capital markets as part of the distribution in violation of the 1933 Act. The main disadvantage to this approach is the SEC filing fee, which is calculated on the amount of securities being registered.[35] If one of the other two options is selected, procedures such as limitations on sales by the international underwriters to the U.S. underwriters should be implemented to restrict the flow of unregistered securities back into the United States.

OVERVIEW OF THE U.S. OFFERING PROCESS

Set forth below is an overview of the process for offering and selling securities in the U.S. capital markets:

- as discussed in this chapter below under the heading "Offering Documents," the issuer and its counsel, with advice from the underwriters or agents and their counsel, prepare the initial offering document, which is normally a prospectus, offering memorandum or similar document that contains or incorporates by reference a description of and financial information about the issuer, descriptions of the securities offered and the relevant transaction documents, and any supplemental offering materials delivered to investors;

- if the offering of the securities is registered under the 1933 Act, the issuer and its counsel, with advice from the underwriters or agents and their counsel, prepare a 1933 Act registration statement (including the prospectus and required exhibits such as legal opinions, certain transaction documents and material contracts), file it with the SEC and, if the issuer is not a WKSI, resolve any SEC staff comments;[36]

- the underwriters or agents and, where counsel is required to deliver a 10b-5 statement regarding the information contained or incorporated by reference in the offering documents, counsel to the issuer and the underwriters, perform the review and investigation of the issuer known as "due diligence," which is discussed in this chapter below under heading "Due Diligence," primarily to ensure that there are no material misstatements or omissions in the offering documents, the registration statement (if the offering is 1933 Act-registered) or any information incorporated therein by reference;

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[35] As of the date of publication, the applicable fee rate for the 2013 fiscal year is $136.40 for each $1 million of securities sold (http://www.sec.gov/news/press/2012/2012-174.htm). The filing fee is subject to adjustment each federal fiscal year, which the SEC periodically announces in Fee Rate Advisories published as press releases on the SEC's web site at http://www.sec.gov/news/press.shtml.

[36] If the issuer qualifies as an EGC, it may confidentially submit a registration statement and amendments to the SEC staff for review, subject to the requirement of a public filing not later than twenty-one days prior to the first road show for the offering. See Chapter 3 (*The Securities Registration and Reporting Process*) and Chapter 5 (*Shelf Registration*).

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- where a comfort letter is required to be provided with respect to financial information contained or incorporated by reference in the disclosure package, the issuer's auditors perform review procedures in order to enable them to provide comfort to the underwriters or agents regarding that information;

- if the securities are to be listed on a U.S. securities exchange, the issuer and its counsel, with advice from the underwriters or agents and their counsel, prepare the listing documentation and file it with the applicable exchange;[37]

- unless the offering is specifically exempt from FINRA requirements,[38] counsel to the underwriters, with advice from the issuer and its counsel, prepare and file with FINRA documentation to show that the underwriting arrangements are fair and reasonable;[39]

- unless the offering is specifically exempt from such requirements,[40] counsel to the underwriters, with advice from the issuer, prepares and files any documents necessary to qualify the offering for sale in any applicable states or other jurisdictions and prepares a "blue sky" survey for the underwriters or agents explaining the investors to whom and the states in which the securities may be offered and sold;[41]

- the issuer, the underwriters or agents and their respective counsel agree the disclosure about the issuer, the terms of the securities to be offered and the description of the transaction documents and, if secured debt securities or covered bonds are being offered, the description of the relevant collateral and other required or relevant disclosure;

- the other transaction documents are prepared, which normally include:

    - the agreement between the issuer and the securities firm or firms that the issuer engages to underwrite or place its securities (the scope, content and name of which varies by product and offering and may be referred to as,

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37 See Chapter 6 (*Listing on U.S. Securities Exchanges*).

38 Offerings exempt from 1933 Act registration, including Rule 144A offerings and offerings of exempt securities, are normally also exempted from FINRA filings. See "*Overview of Securities Regulators and Laws – 'Blue Sky' or State Securities Laws*."

39 See Chapter 3 (*The Securities Registration and Reporting Process*).

40 Offerings of securities that rank equal with or senior to securities of the issuer that are listed on a U.S. securities exchange and that are exempt from 1933 Act registration are normally also exempted from registration in states and other jurisdictions.

41 For further detail, see the discussion under the heading "'Blue Sky' or State Securities Laws" in *An Overview of U.S. Securities Regulators and Laws*.

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among other things, an "underwriting agreement," a "purchase agreement," a "distribution agreement," a "dealer agreement," a "selling agreement" or an "agency agreement");

- if the offering is a conventional private placement,[42] a purchase agreement between the issuer and the investors;
- due diligence question lists for management and the issuer's accountants and, in some cases, a directors' and officers' questionnaire, and a document request list for documentary or "legal" due diligence, as discussed in this chapter below under the heading "Due Diligence";
- in the case of equity securities, the issuer's organizational documents, if necessary;
- in the case of debt securities, the agreement or indenture with the entity (normally a commercial bank or one of its subsidiaries) that acts as issuing and paying agent for the securities and/or in the case of 1933 Act-registered and some privately-placed debt securities, as trustee for the securityholders;
- in the case of debt securities that are secured or are covered bonds, the relevant collateral documents and other arrangements;
- the form or forms of the security being offered;[43]
- opinions, officers' closing certificates and other closing documents, including, as the case may be, 10b-5 statements from counsel to the issuer and the underwriters to the effect that no facts have come to the attention of such counsel that would cause it to believe that the offering documents contain any material misstatements or omit any material information;
- if the securities require a calculation agent, such as floating rate or structured notes, the calculation agency agreement between the issuer and the calculation agent; and
- in the case of book-entry securities, the agreement between the issuer, the issuing agent and DTC;

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[42] See *Accessing the U.S. Capital Markets – Securities Products.*

[43] The terms of the securities may be set forth in the security itself or may be set forth in the document (*e.g.*, indenture or organizational document) under which the security is being issued.

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- in a conventional private placement, the selling agent introduces the investors to the issuer and the issuer negotiates the terms of the securities and the sale price directly with the investors (or with counsel to the investors);

- if the offering is registered, the registration statement is either automatically declared effective in the case of a WKSI or, if not (*e.g.*, in the case of an IPO), any SEC staff comments on the registration statement (and any 1934 Act reports incorporated by reference) are addressed and responded to in one or more amendments to the registration statement and the registration statement, including the preliminary prospectus or "red herring" it contains, is finalized and FINRA approval is obtained;[44]

- if the issuer is only setting up a program or shelf with no immediate take down, the offering document or documents are finalized and a closing occurs at which various transaction documents are signed and delivered as discussed below, but no securities are issued at such time;

- if the issuer is involved in a stand-alone offering or a take down from a program or shelf, the underwriters, with the assistance of the issuer and within applicable guidelines discussed in this chapter below under the heading "Limitations on Publicity," market the securities[45] to potential investors and gather indications of interest in the securities, thereby "building a book" for pricing;

- based on the indications of interest obtained by the underwriters, pricing occurs, whereby the issuer and the underwriters agree to the terms of the securities and the price at which the issuer is to sell them, the underwriting agreement or similar agreement is signed by the parties, the issuer's auditors deliver their comfort letter (if any) and, if the securities are listed on a U.S. securities exchange, trading in the securities is approved on a when-issued basis;

- the underwriters contact investors that have indicated interest in purchasing the securities, inform them of the pricing terms (normally by delivering a term sheet or, in the case of a 1933 Act-registered offering, a free writing prospectus agreed

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[44] As noted in *An Overview of U.S. Securities Regulators and Laws* under the heading "The Jumpstart our Business Startups Act of 2012," an EGC may submit its registration statement to the SEC confidentially and negotiate SEC staff comments in confidence during that time prior to a public filing of a registration statement. However, an EGC must file its registration statement with the SEC at least twenty-one days prior to the first roadshow for its IPO. The comment letters from the SEC staff, as well as the issuer's responses, will be deemed confidential information and will not be made public on EDGAR until at least twenty business days following the effective date of the registration statement.

[45] Marketing normally occurs through the use of a preliminary offering document. In the case of an offering under a program or a shelf, the base offering document is frequently accompanied by a preliminary supplement relating to the terms of the securities. See also the discussion in this chapter below under the heading "Offering Documents."

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upon with the issuer) and confirm the investors' orders and, if the underwriters stabilize the trading price of the securities to ensure an orderly offering, they do so in accordance with the applicable guidelines discussed in this chapter below under the heading "Stabilization and Regulation M"; and

- normally three business days after the pricing[46] of the offering, the closing occurs at which the remaining transaction documents, including the closing documents, are signed and delivered and the securities are delivered by the issuer in exchange for receiving the purchase price from the underwriters or agents or, in the case of a traditional private placement, the investors.

ISSUER CLASSES

Securities Offering Reform, a comprehensive set of rule and form changes adopted by the SEC in 2005[47] ("Securities Offering Reform"), established the following classes of issuers: (i) WKSIs; (ii) "seasoned issuers"; (iii) "unseasoned issuers"; (iv) "non-reporting issuers"; and (v) "ineligible issuers." In addition, in 2012 the JOBS Act created a class of issuer known as EGCs.[48]

WKSIs

WKSIs enjoy the greatest benefits under Securities Offering Reform. An issuer is a WKSI if:

- it is current in its 1934 Act reports and has filed those reports timely in the twelve months and any portion of a month preceding the filing of a registration statement;
- it is eligible to use Form S-3[49] to register a cash offering for its own account;
- as of a date within sixty days of the determination, either:

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[46] Rule 15c6-1 under the 1934 Act establishes three business days ("T+3") as the standard settlement cycle for securities transactions (T+4 is the standard settlement cycle for the sale of securities priced after 4:30 p.m., Eastern time, pursuant to a registered firm commitment underwritten offering). Rule 15c6-1 also permits the parties to establish a longer settlement cycle in exceptional circumstances when T+3 or T+4, as the case may be, is not feasible or when otherwise expressly agreed to by all parties to the transaction (including purchasers of the securities).

[47] See SEC Release No. 33-8591 (July 19, 2005) (http://www.sec.gov/rules/final/33-8591.pdf).

[48] See Jumpstart Our Business Startups Act, H.R. 3606 (January 3, 2012) (http://gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf).

[49] The criteria for use of Form S-3 are described in Chapter 3 (*The Securities Registration and Reporting Process*).

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  - o the value of its common equity securities (whether or not voting) held worldwide by unaffiliated persons is at least $700 million; or
  - o it has issued in registered primary offerings at least $1 billion of non-convertible debt or preferred securities in the preceding three years; and
- it is not an ineligible issuer.

Majority-owned subsidiaries of WKSIs may qualify as WKSIs themselves based on the parent's status if:

- the parent fully and unconditionally guarantees the subsidiary's non-convertible debt or preferred securities;
- the subsidiary securities being registered are guarantees of the debt securities of its parent or the non-convertible securities of another majority-owned subsidiary where such securities are supported by the parent's full and unconditional guarantee; or
- the subsidiary is registering non-convertible investment grade securities.

Issuers of asset-backed securities, foreign governmental issuers, investment company issuers and business development company issuers registered under the 1940 Act are not eligible for WKSI status.

Seasoned Issuers

"Seasoned issuers" are those issuers that do not qualify as WKSIs but that are eligible to make primary offerings of securities on Form S-3.

Unseasoned Issuers

"Unseasoned issuers" are those issuers that are required to file reports under the 1934 Act but are ineligible to make primary offerings on Form S-3. Unseasoned issuers include issuers that voluntarily file reports under the 1934 Act even though they are not obligated to do so. Such unseasoned issuers are not eligible for WKSI status or seasoned issuer status.

Voluntary Filer Status

The facing sheets for Form 10-K require the issuer to state whether it is required to file reports pursuant to the 1934 Act. Issuers who file reports voluntarily must identify themselves as such. Most voluntary filers are obligors on debt securities. Because many issues of debt securities are held of record by less than 300 persons or, in the case of banks and bank holding companies, 1,200 persons, the obligor's reporting obligation under Section 15(d) automatically falls into suspense after the fiscal year in which the associated registration statement became effective. Voluntary filers of this type generally report to comply with indenture covenants to continue reporting, notwithstanding the suspension of

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the statutory duty. The SEC believes that investors should be aware that voluntary filers may, at least as a matter of law under the 1934 Act, stop reporting at any time.

Non-Reporting Issuers

"Non-reporting issuers" are issuers that do not file 1934 Act reports with the SEC voluntarily or otherwise. Generally, this category covers issuers filing their first registration statement with the SEC. Such an issuer becomes subject to 1934 Act reporting obligations upon effectiveness of its 1933 Act registration statement.

Ineligible Issuers

"Ineligible issuers" may not be WKSIs and are subject to certain other disabilities. As defined in Rule 405 under the 1933 Act, ineligible issuers include:

- issuers that are subject to the reporting requirements of the 1934 Act but are delinquent in filing those reports in the twelve months and any portion of a month preceding the filing of a registration statement, except for certain current reports on Form 8-K;[50]
- issuers that are or have been in the past three years a blank check issuer,[51] shell company[52] or penny stock company;[53]
- limited partnerships when offering securities other than in firm-commitment underwritings;

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[50] In the case of an asset-backed issuer, this would also include a delinquency by the depositor of another asset-backed issuer of a class of securities involving the same asset class established by the same depositor.

[51] Rule 419(a)(2) under the 1933 Act defines a blank check company as a "development stage company that (i) has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or other entity or person and (ii) is issuing 'penny stock' as defined in Rule 3a51-1 of 1934 Act."

[52] Rule 405 under the 1933 Act defines a shell company as a registrant, other than an asset-backed issuer as defined in Item 1101(b) of Regulation AB, that has:

(1) no or nominal operations; and

(2) either:

(i) No or nominal assets;

(ii) Assets consisting only of cash or cash equivalents; or

(iii) Assets consisting of any amount of cash and cash equivalents and nominal other assets.

[53] Rule 3a51-1 under the 1934 Act defines "penny stock" generally as an equity security with a price of less than $5.00 which is not listed on a national securities exchange. "Penny stock" typically comprises very low-priced, high-risk, speculative shares in unproven companies.

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- issuers that have filed for bankruptcy or insolvency in the preceding three years;
- issuers, including subsidiaries, that in the past three years have been convicted of specified offenses under the 1934 Act or that are subject to a decree or order of a U.S. or non-U.S. court prohibiting conduct specified in the anti-fraud provisions of the federal securities laws; and
- issuers that are or have been in the past three years subject to certain administrative proceedings under the 1933 Act.

The disqualification for decrees and orders related to the anti-fraud provisions of the federal securities laws will include decrees and orders entered as part of settlements with the government, such as consent decrees, but do not apply to any settlement entered into before December 1, 2005. Disqualifications stemming from a subsidiary's misconduct will only result if the issuer owned the subsidiary at the time of the actions in question, which will prevent an issuer acquiring a new subsidiary from becoming an ineligible issuer as the result of actions taken at a time before the subsidiary was acquired.

The SEC may determine, "upon a showing of good cause," that an issuer otherwise covered by the definition should not be considered an ineligible issuer. The staff has authority under this provision to make the determination that an issuer need not be considered ineligible.

EGCs

Under the JOBS Act, issuers known as "emerging growth companies" or "EGCs" have more limited disclosure requirements and fewer restrictions on "test-the-waters" and research communications.[54] An EGC is an issuer that had total annual gross revenues of less than $1,000,000,000 during its most recently completed fiscal year.[55] Qualification as an EGC will cease upon the first to occur of:

- the last day of the fiscal year during which the issuer has total annual gross revenues of $1,000,000,000 or more;
- the last day of the fiscal year following the fifth anniversary of the issuer's IPO;
- the date on which the issuer has, during the previous three-year period, issued more than $1,000,000,000 in non-convertible debt; and

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[54] See JOBS Act Section 105.

[55] See Section 2(a)(19) of the 1933 Act and JOBS Act Section 101(d).

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- the date on which the issuer becomes a "large accelerated filer," generally meaning that its public float is $700,000,000 or more.[56]

OFFERING DOCUMENTS

The preparation of the offering documents for a U.S. securities offering is a very important task, as these documents form the basis on which the securities are offered and sold. The documents, together with the other information conveyed to investors at the time they decide to purchase offered securities (which we collectively call the "disclosure package"), are also the primary source of liability for issuers, their directors and controlling persons, underwriters and accounting firms.[57] The issuer and its counsel (with input from the underwriters and their counsel, the issuer's auditors and others) normally prepare the offering documents and will review and comment on all other parts of the disclosure package. The issuer, the underwriters and their counsel perform the due diligence discussed in this chapter below under the heading "Due Diligence" with a view to ensuring that the disclosure package, including information incorporated by reference, contains no material misstatements and omits no material information.

Most offerings in the U.S. capital markets (other than common stock offerings) use at least two offering documents. The offering document initially distributed to the investors to solicit their interest is discussed in this chapter below under the heading "Offering Documents–Primary Offering Document." The other offering document (which is typically not used in common stock offerings) discloses the pricing terms and is sent to investors by the underwriters or agents, normally via a Bloomberg message or other electronic means. In a 1933 Act-registered offering, this is a "free writing prospectus." Most offering documents also incorporate information by reference from other documents filed by the issuer with the SEC that are electronically available to investors.

"Test-the-Waters" Communication by EGCs

The JOBS Act permits EGCs and their authorized persons to "test-the-waters" for a contemplated securities offering, which allows those companies to communicate orally or in writing with potential investors who are QIBs or institutional accredited investors. EGCs may make those communications before or after the registration statement is publicly filed with the SEC without being subject to current restrictions on pre-offering communications, although issuers and underwriters are still subject to 10b-5 liability, Section 17 liability and possibly 12(a)(2) liability in connection with these activities. "Test-the-waters" is designed to reduce impediments to conducting a market check.

An issuer must qualify as an EGC in order to rely on Section 5(d) of the 1933 Act for its test-the-waters communications made prior to the public filing of the issuer's registration

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[56] *Id.*

[57] See Chapter 16 (*Liabilities Under U.S. Securities Laws*).

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statement. The SEC staff routinely requests copies of test-the-waters materials to compare them to the filed registration statement.

Free Writing Prospectus

A "free writing prospectus" is any written communication offering for sale securities registered under the 1933 Act, but does not include the prospectus forming part of the registration statement, limited announcements pursuant to Rules 134 and 135, certain materials permitted by the rules for issuers of asset-backed securities or sales literature used after the effective date of a registration statement that is accompanied or preceded by a prospectus satisfying Section 10(a) of the 1933 Act.

Because a free writing prospectus is not a part of the registration statement, Section 11 of the 1933 Act does not impose any liability for misstatements or omissions in its contents. However, any material misstatements and omissions in a free writing prospectus are actionable under Section 12(a)(2) of the 1933 Act. Misleading disclosure in a free writing prospectus may also lead to liability under Section 17(a) of the 1933 Act, which is enforceable by the SEC, but not by private litigants, and liability under Rule 10b-5 under the 1934 Act.

Pre-Filing Free Writing Prospectuses by WKSIs

Rule 163 provides that it is not gun jumping[58] for issuers that are WKSIs to make oral and written communications about an offering of securities prior to filing a 1933 Act registration statement. The written offers are considered free writing prospectuses, must contain a prescribed legend and, with some exceptions, must be filed with the SEC "promptly" upon the filing of the registration statement. There are cure provisions for "immaterial or unintentional" failures to include the required legend or make the required filing. While the SEC in 2009 proposed a rule change that would allow reliance by underwriters and dealers, Rule 163 currently may not be used by prospective underwriters or other offering participants on behalf of a WKSI. Rule 163 is not available to investment companies, business development companies or acquisitions being registered under the 1933 Act.

Post-filing Free Writing Prospectuses

Pursuant to Rule 164, a free writing prospectus may be used by the issuer or any offering participant after the filing of a registration statement. The rule prescribes eligibility conditions and makes provisions for the cure of certain compliance failures, which are similar to the cure provisions in Rule 163. Rule 433 sets out the filing, delivery, notice and recordkeeping conditions to the use of a free writing prospectus.

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[58] For a further discussion of gun jumping, see the discussion in this chapter below under the heading "Limitations on Publicity–Rules That Apply to a 1933 Act-Registered Offering."

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Certain issuers are not eligible to use free writing prospectuses, including investment companies and business development companies and issuers that are, or have been in the past three years, blank check companies, certain shell issuers and penny stock issuers. The ability of ineligible issuers to use of a free writing prospectus is limited to providing descriptions of the offerings, the terms of the securities being offered and, for issuers of asset-backed securities, certain specified information from Regulation AB.

The following conditions apply to the use of the free writing prospectus under Rule 433:

- issuers other than WKSIs must have filed with the SEC a 1933 Act registration statement that includes a prospectus satisfying Section 10 of the 1933 Act;
- unseasoned and non-reporting issuers must make prior or contemporaneous delivery (which might be satisfied by hyperlink access) of the prospectus satisfying Section 10 of the 1933 Act;
- information in the free writing prospectus, "the substance of which is not included in the registration statement," may not "conflict" with information that is part of the registration statement, including 1934 Act reports incorporated by reference;
- the free writing prospectus must include a prescribed legend directing investors to the prospectus in the registration statement;
- subject to certain exceptions, the free writing prospectus must be filed with the SEC, but not as part of the registration statement, by "means reasonably calculated to result in filing no later than the date of first use"; and
- issuers and offering participants must retain copies of any free writing prospectus not required to be filed with the SEC for a period of three years from the first *bona fide* public offering of the securities.

A base prospectus for a shelf offering and a preliminary prospectus are types of prospectuses that satisfy Section 10 of the 1933 Act. In an IPO, the SEC requires an estimated range of the public offering price for satisfaction of Section 10 of the 1933 Act. The delivery requirement applicable to unseasoned and non-reporting issuers generally calls for the use of the most recent prospectus satisfying Section 10 of the 1933 Act. Once available, the final prospectus for such an issuer must accompany or precede any free writing prospectus delivered after effectiveness. If a free writing prospectus is delivered electronically, an active hyperlink to a prospectus satisfying Section 10 of the 1933 Act will satisfy the delivery requirement.

The requirement that the information in the free writing prospectus may not "conflict" with statements in SEC filings at times may be difficult to apply in practice. The limit of the SEC's guidance in the adopting release is that the prohibition will not prevent disclosure that is "different from or additional or supplemental to" the disclosures included in the

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registration statement.[59] In the SEC's view, the inclusion of disclaimers, such as a statement that the free writing prospectus is not a prospectus or offer, would remove the protection of Rule 164, with the result that the free writing prospectus would be an illegal prospectus, and a violation of Section 5 of the 1933 Act. Statements disclaiming that the information is accurate and complete or requiring investors to acknowledge that they have understood the disclosures have historically been disfavored by the SEC and, if used, also would prevent reliance on Rule 164.

The filing requirement normally applies to the issuer itself. If, however, the free writing prospectus was not prepared by or on behalf of the issuer and if the free writing prospectus does not otherwise include material information about the issuer or its securities provided by or on behalf of the issuer, the issuer would not be required to file the free writing prospectus. Information prepared by another party only on the basis of issuer information or derived from issuer information is not be required to be filed. However, any free writing prospectus used or referred to by an offering participant must be filed if it is distributed "in a manner reasonably designed to lead to its broad unrestricted dissemination."[60] The SEC will not consider a dealer's communications exclusively with its own customers, regardless of number, as such a dissemination. The filing requirement applicable to offering participants is independent of the issuer's obligation.

Rule 433(d)(5)(ii) requires a free writing prospectus that describes the final terms of the offering to be filed within two days of the later of the establishment of final terms or the first use of the prospectus describing the final terms.

The exceptions to the filing requirement include provisions designed to prevent some substantively duplicative filings. A free writing prospectus including only preliminary offering terms is not required to be filed. A free writing prospectus for an issuer of asset-backed securities may also be subject to Regulation AB and associated rules. Similarly, any free writing prospectus used in securities offerings in business combinations may be filed pursuant to Rule 425.

Written Communications

In addition to written materials and radio or television presentations, all of which are included in the statutory definition, "written communications" include all graphic communications. All radio and television presentations are deemed to be written communications, without regard to the manner of transmission.

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[59] See *supra* note 47.

[60] See Rule 433(d)(1)(ii) under the 1933 Act.

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Graphic Communications

"Graphic communications" include all forms of electronic media. These include audio and video tapes, fax transmissions, e-mail and Internet web sites, among other things. For example, "blast" voice mails (*i.e.*, recorded voice messages transmitted to many telephones), are graphic communications. Telephone conversations or conference calls and personal voice mail messages from live telephone calls are not graphic communications. An exception is made in the definition of graphic communications for live real-time transmission of roadshow presentations to live audiences. When recorded and retransmitted through an issuer's web site, however, the communication would be considered a graphic communication.

Primary Offering Document

The primary offering document is referred to as a "prospectus" if the offering is registered under the 1933 Act, and is normally referred to as an "offering memorandum" or an "offering circular" (but generally not a prospectus) if the offering is not 1933 Act-registered. If the securities are offered under a program or shelf registration, there is normally a "base" prospectus or offering memorandum and one or more supplemental prospectuses or offering memoranda describing the specific terms of each individual offering.

The contents of the offering documents vary depending upon the type of offering, the type of security and the type of issuer. The disclosure requirements of the 1933 Act and the SEC's rules prescribe the form and content requirements for prospectuses used in a registered offering.[61] Although the 1933 Act contains no information requirements for most private placements and other exempt offerings, in Rule 144A offerings where counsel is required to deliver 10b-5 statements regarding the offering documents (particularly offerings of long-term, fixed-income securities and equity securities), market practice generally is to follow the disclosure requirements for 1933 Act-registered offerings to the extent possible. This practice helps protect transaction participants against potential investor claims.

Offering documents for certain exempt offerings do not follow the disclosure requirements for 1933 Act-registered offerings. For example, the offering documents for commercial paper and most extendible note offerings normally contain a very short description of the issuer and a description of securities and tax consequences and other matters that are material to an investment in those securities. In these cases, no 10b-5 statement from counsel is required. The rationale is that these types of securities are less risky to investors because they have shorter-term maturities and are highly rated and the natural investor base is very sophisticated, so risk of loss is disproportionately lower than the cost of generating sizable offering documents. In other cases, such as bank issuers or

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[61] See Chapter 3 (*The Securities Registration and Reporting Process*), Chapter 4 (*Disclosure Requirements*) and Chapter 5 (*Shelf Registration*).

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municipal bond issuers, a different disclosure and regulatory scheme applies, and disclosure is provided to the extent required by and in accordance with the requirements of that scheme.

In many cases, the underwriters or agents wish to market the offering and build a book of interested investors before committing to purchase the securities from the issuer. In that case, the underwriters will use a preliminary offering document that includes all the required information other than the pricing information, such as interest or dividend rate and sales price, which will be determined and agreed upon by the issuer and the underwriters following the marketing and book-building process. In the case of offerings under a program or shelf, the base offering document and any base supplemental offering documents may be used to market the securities without a separate preliminary offering document if the terms of the securities being marketed are sufficiently described in those documents. Customarily, upon completion of the marketing efforts, a term sheet setting forth the terms of the offering and the securities is agreed upon by the issuer and the underwriters and, in the case of offerings of fixed income securities, distributed to potential investors that have shown an interest in purchasing the securities, and their orders are confirmed.

The filing obligations with respect to prospectuses, prospectus supplements, term sheets and other offering materials with respect to a registered securities offering are discussed in Chapter 3 (*The Securities Registration and Reporting Process*).

Prospectus Delivery

In one of the most significant changes to securities offerings, Securities Offering Reform effectively abolished the requirement for delivery of the final prospectus to purchasers in nearly all cases. Noting the widespread use of the Internet, the SEC accepted the proposition that the accessibility by electronic means to the disclosure documents required by the 1933 Act should be treated as the equivalent of delivery to investors. The SEC's acceptance of the access-equals-delivery model does have some limits. It does not extend to all registered offerings or to all types of documents required to be delivered to investors under the federal securities laws.

Prospectus Delivery Generally

Rule 172 under the 1933 Act provides that a prospectus meeting the requirements of Section 10(a) will be deemed to accompany or precede the delivery of a security sold under a registration statement if such a prospectus is timely filed with the SEC's electronic filing system. Failed attempts to file made in good faith and with reasonable efforts will be deemed to satisfy the rule if the issuer files the prospectus as soon as practicable.

Rule 172 expressly permits sending confirmations under Rule 10b-10 under the 1934 Act and notices of allocations of sale before the final prospectus is available or filed. The SEC specifically noted that the relief provided by Rule 172 would extend to a market-making prospectus, the offering document required when a dealer makes a market in securities of an affiliate, provided only that a current final prospectus is filed with the SEC.

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A dealer's obligation to deliver a preliminary prospectus to investors in IPOs, which is required by Rule 15c2-8 under the 1934 Act, may not be discharged through Rule 172. It is also important to note that, except for WKSIs and seasoned issuers, actual delivery of a prospectus permitted by Section 10 of the 1933 Act (or, at least, provision of a live hyperlink) is required as a condition to use of a free writing prospectus.

Rule 172 is unavailable for investment company issuers and business development company issuers and in cases where the issuer or an underwriter or participating dealer is the subject of a pending SEC proceeding in connection with the offering. The rule also does not affect prospectus delivery requirements in business combinations and exchange offerings or in employee benefit plan offerings registered on Form S-8.

Disclosure Duty

A disclosure duty is created by Rule 173 under the 1933 Act. In any transaction covered by Section 5(b)(2) of the 1933 Act, which includes all registered sales by issuers and underwriters, not later than two business days following the completion of such sale, there must be delivered to purchasers a copy of the final prospectus or, in lieu of such prospectus, a notice to the effect that the sale was made pursuant to a registration statement or in a transaction in which a final prospectus would have been required to have been delivered in the absence of Rule 172. Most underwriters deliver the notice in lieu of the final prospectus, and include the notice in the Rule 10b-10 confirmation. Alternatively, the final prospectus may be delivered. A person required to provide notice under Rule 173 must honor any request from its purchasers for a copy of the final prospectus. In such a case, settlement of the purchase may still proceed before delivery of the final prospectus.

Rules 172 and 173 are independent, which is to say that compliance with Rule 173 is not necessary to establish the exemption from prospectus delivery. Inter-dealer transactions and transactions ineligible under Rule 172 are not subject to Rule 173.

Prospectus Delivery for Trades on a Securities Exchange

Rule 153 under the 1933 Act affords relief from the prospectus delivery requirements of the 1933 Act for sales to brokers and dealers in transactions effected on national securities exchanges, including NASDAQ, or through alternative trading systems. The conditions to the rule are that the related registration statement is effective, that the SEC has not taken certain administrative actions in respect of the offering under Section 8 or 8A of the 1933 Act (such as a stop order), and that the prospectus satisfying Section 10(a) is filed with the SEC. No filing with the exchange or other market is required.

Information Incorporated by Reference

In many cases offering documents "incorporate by reference" information from other documents filed with the SEC. As a general matter, information incorporated by reference into offering documents is considered part of the offering documents and therefore part of the disclosure package on which an investor makes its decision. Incorporation by reference

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makes it easier to draft offering documents as the incorporated information has already been prepared with a view to use in an offering. This process also facilitates updating a program or shelf much easier and enables an issuer to use the same information about itself in multiple contexts.

1933 Act-Registered Offerings

In the case of registered offerings, reporting companies under the 1934 Act that are eligible to incorporate by reference information into their prospectuses may do so by referring investors to the information they file with or, in some cases, submit to the SEC under the 1934 Act. The SEC's web site (http://www.sec.gov) is easily accessible and its EDGAR system (http://www.sec.gov/edgar/searchedgar/companysearch.html) includes the 1933 Act and the 1934 Act filings made by reporting issuers. Issuers registering an offering on a Form S-1 registration statement may incorporate by reference their prior 1934 Act filings after they have filed an annual report required by Section 13(a) or Section 15(d), but are not permitted to incorporate by reference future filings. Any issuer that registers an offering on a Form S-3 registration statement incorporates by reference its prior and future 1934 Act filings into its prospectus.

Private Placements, Including Rule 144A Offerings

Offering documents used in private placements, particularly Rule 144A offerings, commonly incorporate information by reference to the 1934 Act reports filed by issuers with the SEC, particularly those that frequently offer and sell securities in the United States. In the last few years, particularly in connection with securities offerings by non-U.S. issuers that have de-registered under the 1934 Act and structured finance vehicles that are not subject to registration and reporting under the 1934 Act, a practice has developed whereby offering documents used in private placements have incorporated by reference information published on a cul-de-sac on the issuer's web site or a special web site maintained by the issuer. The information on the cul-de-sac or special web site is typically updated in much the same way as the issuer would update its 1934 Act information. These cul-de-sacs or special web sites do not link to any other web site. The cul-de-sac or special web site essentially functions as an electronic component of the offering documents.

The most prevalent version of this technique is that the cul-de-sac will include only information about the issuer that is prepared for use by a U.S. investor, but does not refer to any particular offering. A cul-de-sac of this type is freely accessible by any party and effectively serves as a substitute for the SEC's web site. Another method frequently employed in the structured finance market is that the cul-de-sac is password protected, is accessible only by investors being offered the particular securities and, in addition to information about the issuer, contains specific information about the securities offering and any related collateral.

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Other Information in the Disclosure Package

Any additional information that may be used to market an offering of securities in the U.S. capital markets, such as e-mails, cover letters and roadshow materials, may also be considered part of the disclosure package for 1933 Act liability purposes, as noted in the discussion in this chapter below under the heading "Limitations on Publicity."

Disclosure Package at Time of Sale

As discussed in Chapter 16 (*Liabilities Under U.S. Securities Laws*), for purposes of establishing disclosure liability under Section 12(a)(2) of the 1933 Act for material misstatements or omissions of material information, Rule 159 under the 1933 Act provides that the relevant disclosure is the information conveyed to the investor up to the point, known as the "time of sale," when the investor becomes committed to purchase the securities. In most cases, the time of sale is considered to be when the investor tells its broker it will purchase the offered securities. As a result, since the disclosure package for a marketed securities offering at the time of sale is typically not the final prospectus or other final offering document but rather the preliminary offering document or base offering document or documents and any other information, including the terms sheet with pricing information and, in certain cases, roadshow materials, distributed by the issuer or the underwriter and received by the investor at or prior to the time it commits to purchase the offered securities, it is that disclosure package (and not the final prospectus or other offering document) that constitutes the basis for establishing disclosure liability under Section 12(a)(2) of the 1933 Act. In the case of securities purchased by underwriters without having broadly solicited prospective investors (known as "bought" deals), the final prospectus or offering document would still constitute the basis for disclosure liability under Section 12(a)(2) of the 1933 Act (so long as it was delivered at or prior to the time of sale). In all registered offerings, disclosure liability under Section 11 of the 1933 Act will be based upon the prospectus.

DUE DILIGENCE

Due diligence refers to the appropriate level of investigation to be performed in connection with a U.S. securities offering. The level of diligence required in a particular offering will vary depending, among other things, on the type of offering, the securities offered, the issuer involved and the sophistication of the potential investors and their level of involvement in the offering process.

It is generally acknowledged that a registered offering requires the most rigorous investigation. The level of diligence performed in connection with some exempt offerings, such as Rule 144A offerings, is comparable to that performed in connection with 1933 Act-registered offerings. The time and effort required to perform due diligence will depend upon the nature of the issuer and the complexity of its business. If the lead underwriters and their counsel have performed a due diligence investigation of the issuer in the recent past, their familiarity may shorten the time needed for a sufficient investigation. To illustrate, an initial public offering by an issuer that operates primarily in politically or economically unstable parts of the world or whose business is in a volatile industry would require a lengthier

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investigation than those appropriate in an offering by a 1934 Act-registered issuer with a stable business that frequently accesses the public capital markets.

Due diligence in connection with offerings of securities such as commercial paper, U.S. bank certificates of deposit and extendible notes are customarily the least rigorous. In most of these cases, investigation is limited to the underwriters checking their internal knowledge about the issuer, including any research on the issuer, and brief discussions with management at the time of the offering.

In connection with conventional private placements, the investors conduct their investigation and analysis directly with the issuer.

Origins and Purpose

The practice of employing due diligence procedures to verify the information contained or incorporated by reference in offering documents originates from the liabilities imposed by Sections 11 and 12(a)(2) of the 1933 Act, and the due diligence defenses thereunder available to underwriters.[62] Section 11(b)(3) of the 1933 Act allows an affirmative defense to liability for any defendant (other than the issuer) if it shows that, after reasonable investigation, it held the reasonable and actual belief that the registration statement included no material misstatement or omission. Section 12(a)(2) provides a similar defense to a defendant who did not know and in the exercise of reasonable care could not have known of the material misstatement or omission in a prospectus. Recognizing the importance of this defense, underwriters and their counsel have developed due diligence procedures designed to demonstrate that they have performed a "reasonable investigation" or taken "reasonable care" to protect themselves from liability.

The purpose of due diligence in any securities offering can be summarized as follows:

- verify that the disclosure regarding the issuer is complete and correct and consistent with the applicable disclosure standards, which may involve more than U.S. disclosure standards if the offering is made or the securities are listed outside the United States;

- ensure that there are no impediments to the offering (*e.g.*, no pre-emptive rights, no covenants that prohibit the offering, no third-party consents required, the issuer satisfies the corporate governance requirements of Sarbanes-Oxley, etc.);

- reduce the risk that the securities that the investors receive are less valuable than they expected, thereby increasing the likelihood of claims against the issuer and the underwriters;

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[62] These provisions, as well as other liability provisions under U.S. securities law, are discussed in detail in Chapter 16 (*Liabilities Under U.S. Securities Laws*).

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- establish an affirmative defense to any claim involving the offering; and
- provide fair disclosure to investors and protect the reputation of the issuer and the underwriters.

Main Aspects of Due Diligence

It is customary for the underwriters and their counsel to lead the due diligence process, although the issuer and its counsel, the issuer's auditors, any foreign counsel and any required experts (*e.g.*, patent counsel, engineers, etc.) all may participate in the process. Due diligence also benefits the issuer to the extent that it reduces the risk of a claim being made by an investor.

The main aspects of due diligence, which have been developed over the years with the benefit of custom, practice and case law, include the following:

Interviews with the Issuer's Management, its Auditors (and, if warranted, its Audit Committee) and Directors' and Officers' Questionnaires. These usually cover questions previously composed and conveyed by the underwriters or their counsel as well as questions that arise during a due diligence interview. These interviews usually occur at the beginning of the offering process or the establishment of a program or a shelf, ideally early in the drafting process for the offering documents, and are updated during the offering process or during the life of the program or the shelf. In some cases, particularly IPOs, the directors and principal officers of an issuer respond to a questionnaire to ensure accurate disclosure about such matters as their compensation, share ownership and any conflicts of interest with the issuer, in addition to affirming their qualification to be employed or engaged by an issuer with 1933 Act-registered securities or U.S. securities exchange-listed securities.

Reviewing the Documents of the Issuer and its Subsidiaries. In most offerings, counsel to the underwriters submits a document request list to the issuer and its counsel, a call or meeting is convened to discuss the document request list (which lists all documents that are believed to be material to the issuer and its subsidiaries) to focus the review process on those documents that are material, and counsel to the underwriters and the issuer typically thereafter review the documents. This document review ideally occurs early in the drafting process for the offering documents and is updated during the offering process or during the life of the program or the shelf. The documents reviewed are generally extensive, tailored to the particular issuer and, at a very high level, include the organizational documents, board and committee minutes and presentations for the issuer and its subsidiaries, directors' and officers' questionnaires, material instruments and agreements, corporate policies and procedures, accountants' letters to management and management responses, attorney's litigation and regulatory compliance letters to accountants and litigation files of the issuer and its subsidiaries.

Sarbanes-Oxley Due Diligence. If an issuer is a 1934 Act reporting company, through a combination of document review and interviews with management, counsel to the underwriters will perform a due diligence review of compliance by the issuer with the

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corporate governance and other requirements of Sarbanes-Oxley, Dodd-Frank, the FCPA and the SEC's rules thereunder, as well as other applicable laws and regulations.

Drafting and Negotiating Sessions. Perhaps the best due diligence is conducted at the drafting sessions for the offering documents, where the underwriters and their counsel review and discuss the issuer's disclosure, and the negotiations over the transaction documents, particularly the representations and warranties in the underwriting agreement and, in the case of a debt securities offering, the covenant package. Through these reviews and discussions, underwriters and even the issuer may become aware for the first time of matters that are material to the offering. The due diligence benefits of drafting issuer disclosure and negotiating issuer representations, warranties and debt covenants are obviously not as great in the case of 1934 Act reporting issuers, issuers that have "standard" underwriting agreements or issuers of investment grade securities.

Backup. Underwriters' counsel also often submits a backup request list to the issuer in order to verify the source of industry statistics, market share and similar data included in the offering documents. Backup data requested may also include, where material, issuer information such as number of employees, number of offices and other statistical information about the issuer that the issuer's auditors are not able to comfort. Other forms of backup include visiting the major sites where an issuer conducts its business to confirm their existence and condition and contacting the issuer's major suppliers and customers. These other forms of backup generally apply to industrial companies that are first-time issuers, though in some cases it may be appropriate to periodically repeat some or all of these procedures.

Experts and Other Third Parties. In some cases, the presentation of an issuer's business or financial condition is dependent on experts. This is the case, for example, in the mining and natural resources industries where independent engineers are responsible for developing or verifying reserves and other similar data. Also, some offering documents contain or incorporate by reference an industry, country or regulatory report prepared by a third party. Underwriters of issues of covered bonds and other securities backed by pools of assets often want comfort on the assets involved. In such cases, in addition to interviewing the issuer's management on these matters, the underwriters and their counsel will interview the independent expert or other third party, verify its independence and credentials and receive, at the closing of a stand-alone offering, a program or a shelf and at periodic updates of a program, a signed report or certification from the independent expert as to the report or data.

Auditors' Comfort Letter. This letter is intended to provide the underwriters or agents with comfort on at least four areas: (i) the auditor is independent; (ii) any interim financial statements are prepared on the same basis as the audited annual financial statements; (iii) the financial information contained or incorporated by reference in the offering documents has been accurately derived from the issuer's accounting records; and (iv) on a negative assurance or, in certain cases, specified-procedures basis, the existence and quantification of any negative changes in specified financial performance and condition measures since the most recent financial information about the issuer included or

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incorporated by reference in the offering documents or the most recent comparable financial reporting period. The comfort letter is generally in the applicable form established pursuant to AU-C 920.[63] Comfort letters are typically delivered at the time of the pricing of a stand-alone offering and updated in short form at the closing.

Comfort letters that are required late or early in an issuer's fiscal year raise issues that are discussed in the AICPA's 2005 White Paper. See http://www.thecaq.org/resources/secregs/pdfs/otherguidance/Comfort_Letter_Procedures.pdf .

To obtain a comfort letter for a Rule 144A offering, the underwriters or agents are required by the auditor to deliver a letter to the issuer's auditor representing that the due diligence procedures being followed in the Rule 144A offering process are substantially similar to those that would be followed in the context of a 1933 Act-registered offering. In some cases, in order to obtain a comfort letter where a Regulation S offering is combined with a Rule 144A offering or 1933 Act-registered offering, the underwriters or agents may be required by the auditor to enter into an arrangement letter with the issuer's auditors which, among other things, establishes AU-C 920-type procedures for the Regulation S offering. In any such case, two comfort letters are typically delivered, one for the U.S. offering and one for the Regulation S offering.

Comfort letters, and any required representation letters and arrangement letters, are also typically delivered at the time of the establishment of a program or shelf, each time the program or shelf is updated with financial information for a new annual or interim fiscal period and, in some cases, at the time of a sizable take down off the program or shelf.

***Closing Papers, Legal Opinions and 10b-5 Statements*.** Closing papers include (i) signed transaction documents (unless previously delivered at the establishment of the program or shelf), (ii) third-party certification of the issuer's corporate existence and, if applicable, good standing in the jurisdictions in which it operates, (iii) an issuer secretary's certificate that certifies the issuer's organizational documents, transaction resolutions and authorizations, completeness of the minutes of the issuer and its subsidiaries, the incumbency of officers signing the transaction documents and closing papers, (iv) a bring-down certificate pursuant to the underwriting agreement, normally signed by the issuer's CEO and CFO or similar officers, that confirms satisfaction of the underwriting agreement's closing conditions and re-affirms representations and warranties, (v) any additional certificates needed to support the legal opinions being delivered or to "bridge gaps" in the comfort underwriters receive from the issuer's auditors, legal counsel or otherwise, and (vi) cross-receipts if securities are being sold.

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[63] AU-C 920 is available at http://www.aicpa.org/research/standards/auditattest/downloadabledocuments/au-c-00920.pdf.

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The issuer's counsel delivers opinions that address (i) corporate matters such as the issuer's corporate existence, capitalization and ownership of subsidiaries, the absence of defaults and violations by the issuer and of material litigation against the issuer, and any regulatory and similar disclosure in the offering documents, (ii) transactional matters such as the issuer's authorization of the transaction, the validity of the transaction documents and the securities being sold, the accuracy of the description of the securities and the transaction documents and any tax or similar disclosure about the securities, compliance with or exemption from the 1933 Act registration requirements, compliance with SEC form requirements (if 1933 Act-registered), all consents and filings for the offering and sale have been obtained, the offer and sale does not contravene or conflict with any of the issuer's material contracts or organization documents or any applicable laws or regulations and, in some cases, the absence of a requirement for the issuer to register under the 1940 Act and (iii) any additional issues that may be relevant to the issuer or that may have arisen during the course of the U.S. offering process.

In addition to delivering legal opinions, counsel to the issuer and counsel to the underwriters are typically asked to deliver a "10b-5 statement" to the underwriters that confirms nothing has come to such counsel's attention to cause it to believe that the registration statement (in the case of a 1933 Act-registered offering) or the offering documents (in the case of a 1933 Act-exempted offering) contain or incorporate by reference any material misstatement or omit any material information. Rule 10b-5 statements carve out financial and sometimes statistical information, as well as "expertized" information,[64] and are not "opinions" as the matters are not, strictly speaking, opinions as to legal matters but rather a statement of a belief as to factual matters. However, as a result of having to deliver a 10b-5 statement with respect to information contained or incorporated by reference in the offering documents, counsel plays a very active role not only in the drafting of the offering documents, but also ensuring that the other aspects of due diligence are conducted to such counsel's satisfaction; hence the 10b-5 statement is viewed as a valuable due diligence component.

Closing papers, legal opinions and 10b-5 statements are typically delivered at the closing of a stand-alone offering, at the time of the establishment of a program or shelf and each time the program or shelf is updated with financial information for a new annual or interim fiscal period and, in some cases, at the time of a sizable take down off the program or shelf.

For a further discussion of issues that arise in connection with due diligence for program or shelf registrations, see Chapter 5 (*Shelf Registration*).

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[64] Potential liabilities with respect to "expertized" information are discussed under the heading "1933 Act Registration Statement Liability–Due Diligence Defense" in Chapter 16 (*Liabilities Under U.S. Securities Laws*).

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LIMITATIONS ON PUBLICITY

There are at least two important reasons to limit publicity in connection with a U.S. securities offering. The first is that the 1933 Act and the SEC's rules regulate the manner of offering securities in the U.S. capital markets, including permissible publicity. It is important that none of the transaction participants violate these rules, as to do so could result in a delay or cancellation of the offering, the expulsion of an underwriter from the syndicate or possible liability or SEC enforcement action. The second reason is that inadvertently published information could become part of the disclosure package and thus expose the issuer and the underwriters to liability.

Once an issuer and an underwriter or agent commence work on a U.S. offering, the transaction parties should not discuss or otherwise publicize the offering outside the working group and any regulatory and securities exchange participants in the transaction. The issuer and the underwriters will need to ensure, based on the advice of counsel, that their other activities, be they corporate announcements, research reports, analysts presentations or other communications, do not violate the SEC's manner of offering rules or inadvertently result in adding unintended information to the disclosure package.

Particularly in the case of IPOs, issuer's or underwriters' counsel would normally provide guidance on the publicity guidelines to be followed a securities offering involving the U.S. capital markets. Where the offering involves multiple jurisdictions, such guidance would address the issues that often arise due to competing regulatory schemes that may, for example, require publicity even though the SEC's rules would prohibit the publicity. Like many law firms, Sidley regularly provides guidance on this subject for our clients.

In limiting their publicity and as part of the due diligence process, U.S. issuers that have a class of securities registered on a U.S. securities exchange or that are required to file periodic reports under the 1934 Act need to be mindful of their market disclosure obligations under Regulation FD, which is discussed in Chapter 7 (*Ongoing Reporting and Other Requirements*).

Rules That Apply to a 1933 Act-Registered Offering

In the case of a 1933 Act-registered offering, with some exceptions for WKSIs and EGCs discussed below, it is a violation of the registration requirements of the 1933 Act to make any offers before filing a registration statement and, after filing the registration statement, to make written offers other than by means of a prospectus, which includes a preliminary prospectus or "red herring." This is called "gun jumping." Gun jumping could result in the cancellation or delay of an offering or the expulsion of one or more underwriters from an offering. It should be noted that, even though a particular form of communication is not gun jumping, the contents of that communication may nevertheless become part of the disclosure package for 1933 Act liability purposes.

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Permitted publicity about a 1933 Act-registered offering includes the following, as well as certain matters discussed in this chapter below under the headings "Research Reports" and "Roadshows."

Pre-Filing Notice of Proposed Registered Offering. Rule 135 permits advance notice of an offering to the market if the notice states that the offering will only be made by means of a prospectus and contains no more than the name of the issuer, the title, amount and basic terms of the securities offered and a brief statement of the manner and purpose of the offering. The notice cannot name the underwriters. This notice would generally be issued prior to the filing of the registration statement with the SEC and is normally published when the issuer determines the offering is material to its existing securityholders.

Post-Filing Notice of Registered Offering. Pursuant to Rule 134, once an issuer has filed a registration statement for a registered offering, a limited announcement concerning the issuer (such as its name, place of formation, address and telephone number) and the securities being offered (such as designations and ranking, CUSIP number and listing information) is permitted to be published. The intended application of offering proceeds and type of underwriting may be included in the announcement, but only if the same information has been disclosed in the prospectus forming part of the registration statement. Issuers of asset-backed securities may identify parties such as the servicer, sponsor or depositor and may include information concerning the asset class of the transaction and any credit enhancement. Rule 134 allows identification of underwriters in the syndicate generally, as well as the managers of the offering. The dates, times and locations of roadshows may be included in the announcement. Offering procedures, such as subscription procedures for on-line offerings, are specifically permitted to be disclosed.

The availability of Rule 134 is conditioned on the availability of a prospectus permitted by Section 10. As noted, the SEC's view is that the prospectus for an issuer's initial public offering is not such a prospectus without a *bona fide* estimate of the price to the public. Rule 134, as interpreted by the SEC staff, may be used by an IPO issuer before an estimate of the pricing range if the communication relying on the rule does not include any other information that would be dependent on the public offering price. Such prohibited information is not confined to the price itself. In the case of fixed-income securities, such information includes final maturity, interest rate, yield, and any rating assigned to the securities.

Rule 134 requires the inclusion of legends informing readers of the availability of the prospectus. Notices complying with the rule are deemed not to be prospectuses or free writing prospectuses.

Issuer Communications More than Thirty Days Prior to Filing. Rule 163A under the 1933 Act provides that any communication made by an issuer more than thirty days before the filing of a registration statement that does not reference a registered securities offering is not considered gun jumping, though it may constitute part of the disclosure package for purposes of liability under Section 12(a)(2) of the 1933 Act. The issuer must take reasonable steps to prevent further distribution of the communication during the

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thirty-day period. Rule 163A is not available in connection with M&A transactions or to investment companies, business development companies or current or certain former blank check, shell or penny stock companies. Rule 163A, among other things, provides an SEC-sanctioned "cooling off" period for any gun jumping activity that occurs while preparing for an SEC-registered offering.

Free Writing Prospectuses. Free writing prospectuses used as discussed above may be used without causing a gun jumping violation.

Testing the Waters Communications by EGCs. The JOBS Act permits EGCs to "test-the-waters," which allows those companies to communicate orally or in writing with potential investors who are QIBs or institutional accredited investors. Those communications may be made before or after filing the registration statement. Caution is warranted, however, as these communications are not excluded from potential liability under Section 12 of the 1933 Act.

Regularly Released Business and Forward-Looking Information. Rule 168 allows 1934 Act-reporting issuers (other than investment companies and business development companies), certain foreign private issuers and, except in the case of forward-looking information, certain participants in ABS transactions to publish factual or forward-looking information. "Factual business information" is defined to include information about the issuer, its business or financial developments, advertisements or other information about its products or services and dividend notices. "Forward-looking information" is defined to include projections of financial measures, statements about plans and objectives for future operations, statements about future economic performance (including MD&A-type information) and related assumptions. The communication may not contain information about the offering. An issuer may only take advantage of this rule if it has previously released or disseminated factual business information in the ordinary course of its business and the timing, manner and form in which the information is released is materially consistent with its similar past communications. While the requirement for "ordinary course" communication may not prohibit communications made on "an unscheduled or periodic basis," the issuer should take into account the nature of the event triggering the communication in assessing the availability of this rule.

News Media and Selling Materials. Rule 433 under the 1933 Act provides that historical information concerning the issuer, specifically identified as such and segregated in a separate section of the issuer's web site, will not be considered a current offer of securities unless used in connection with a pending offering. As a result, an issuer that maintains a properly identified archive of press releases, for example, need not be concerned that the historical information included in the archive will be subject to the free writing prospectus rules. Publications and broadcasts concerning a registered offering that constitute offers will be considered a form of free writing prospectus if the issuer or an offering participant "provided, authorized, or approved information" to a publisher or broadcaster of the information.

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Covered media communications are subject to a filing requirement within four days after the issuer or offering participant becomes aware of the dissemination of the communication. The legending requirement of the rule would be satisfied through inclusion of the prescribed notice on the filed document.

Rule 433(f) generally requires that the publisher or broadcaster of the information must be independent of the issuer and any other person participating in the distribution. An exception is made for issuers in the business of publishing or broadcasting whose publications may include business and financial news. To rely on Rule 433, such an issuer must have established policies and procedures making editorial content of its publications and broadcasts independent of securities offering activities and any publication or broadcast relying on the rule must have been made in the ordinary course.

Rule 433 does not affect the use of sales literature (*i.e.*, written offering materials used after the effective date of a registration statement). Subject to the prior or contemporaneous delivery of a prospectus satisfying Section 10(a), such materials are not considered to be any type of prospectus under the statutory definition of the term.

Rules that Apply to Unregistered Offerings, Including Rule 144A Offerings

The SEC's publicity rules for unregistered offerings are of primary importance to private placements pursuant to Section 4(a)(2) of the 1933 Act, particularly Rule 144A offerings, where it is important that publicity does not impact the issuer's ability to take advantage of the private placement exemption. While there are a number of applicable conditions to this exemption, as discussed in Chapter 8 (*Exempt Offerings and Securities*), the most important in this context, as of the date of publication of this volume, is that there not be a public offering (*i.e.*, that neither the issuer nor any other transaction participant offer or sell the securities by any form of general solicitation or general advertising). However, as part of the implementation of the provisions of the JOBS Act, the SEC has proposed rules that would permit general solicitation and advertising.[65]

The SEC publicity rules for a 1933 Act-registered offering may be considered by analogy by counsel in determining whether a particular communication would impact the private placement exemption or the Regulation S exemption or whether a particular communication should be considered part of the disclosure package.

Notice of Proposed, Pending or Completed Unregistered Offerings. Rule 135c under the 1933 Act, like Rule 135, its counterpart for registered offerings, is intended to permit the issuer to inform existing securityholders of information it considers material to them. Under the safe harbor of Rule 135c under the 1933 Act, an issuer that is required to file 1934 Act reports may publish a notice that it proposes to make, is making or has made an

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[65] See SEC Release No. 33-9354 (August 29, 2012) (http://www.sec.gov/rules/proposed/2012/33-9354.pdf). See also the discussion on this topic in Chapter 8 (*Exempt Offerings and Securities*).

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offering of securities not registered or required to be registered under the 1933 Act so long as such notice (i) is not used for the purpose of conditioning the U.S. capital markets, (ii) states that the securities will not be and have not been registered under the 1933 Act and may not be offered or sold in the United States absent registration or an applicable exemption from registration requirements and (iii) contains no more than specified information that identifies the issuer and the securities. A copy of such notice must be filed with the SEC under the 1934 Act.

RESEARCH REPORTS

Recommendations and other research reports relating to an issuer may not be distributed in the United States until after the completion of the securities offering unless the issuer and the research reports meet the requirements of Rules 137, 138 or 139 under the 1933 Act. Where the U.S. offering is part of an international offering, these restrictions generally also apply to the international underwriters.[66]

Recommendations and other reports published by brokers and dealers can raise issues under Section 5 of the 1933 Act when published around the time of a registered securities offering. Rules 137, 138 and 139 immunize certain recommendations and reports from characterization as illegal offers or as impermissible types of prospectuses. All three rules are safe-harbors.

Research by Non-Participating Broker or Dealer

Rule 137 covers any broker or dealer communications when the broker or dealer has not participated and does not participate in a registered securities distribution and does not propose to do so. The broker or dealer may not have received, directly or indirectly, any compensation for the publication or distribution of the report from any person with an interest or participation in the issuer's securities offering or in its securities. This rule specifies the types of payments that are permitted and those that are prohibited.

The communication in question must have been made in the ordinary course of the broker's or dealer's business. The rule is available for reports concerning any issuer other than an issuer that is, or has been in the past three years, a blank check or shell issuer or a penny stock issuer. The rule permits the publication of research on initial public offerings by disinterested parties. Distribution of independent research by an offering participant, however, is not permitted.

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[66] The practice with respect to the distribution of research reports outside the United States may vary, subject to local laws, in cases in which the non-U.S. offering is not registered under the 1933 Act. In connection with international securities offerings, various underwriters have adopted procedures for distributing research reports outside the United States prior to commencement of the offering. These procedures are designed to ensure that the reports are not distributed in the United States prior to or during the offering.

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Research by Participating Broker or Dealer

Rule 138 provides a dispensation from Section 5 for participants in a distribution of securities who have published research in certain circumstances. What the rule contemplates is a mismatch between the securities that are the subject of the distribution and the securities that are the subject of the research. To illustrate, if a dealer has published a report concerning an issuer's non-convertible debt securities or preferred stock, the report will not be construed as an offering before the filing of a registration statement or as an illegal form of prospectus if the dealer then participates in the registered distribution of the issuer's common stock. To rely on this rule, the broker or dealer must have published reports on the type of security in the past, although it need not have reported on the issuer's securities. The issuer in question must be current in its periodic reports with the SEC.

The rule is unavailable for the securities of any issuer that is or has been within the past three years a blank check issuer, a shell issuer or a penny stock issuer. Rule 138 provides that reports allowed by the rule will not be considered forms of communications that could jeopardize reliance on the exemptions for unregistered sales exclusively to certain institutional purchasers under Rule 144A or exclusively outside the United States under Regulation S.

Issuer and Industry Research Reports

Rule 139 covers the publication of both issuer and industry research reports. Subject to satisfaction of the rule's conditions, a broker or dealer may participate in an issuer's registered offering even though it has recently published research on the issuer or on the issuer's industry. The research will not be considered a prospectus or an offering of the issuer's securities before the filing of a registration statement.

Issuer-Specific Reports as Covered by Rule 139(a)(1). Issuer-specific reports are covered by Rule 139(a)(1) if the U.S. issuer is eligible to make primary offerings on Form S-3.

For U.S. issuers that are WKSIs and seasoned issuers, the time for determination is the later of the date the issuer most recently filed a registration statement on Form S-3 and the date of the most recent amendment filed for the purpose of satisfying Section 10(a)(3), which specifies the maximum age of information permitted in a prospectus. Because the staff of the SEC construes an issuer's filing of its annual report on Form 10-K to be the equivalent of the filing of such an amendment, the 10-K filing date will be used for purposes of this determination. As of that date, the issuer's common equity held by unaffiliated persons must have been at least $75 million or the issuer must be offering investment grade securities. "As of the date of reliance" in Rule 139, which means the date the broker-dealer publishes the report and each date thereafter it distributes the report, the issuer must have timely filed all 1934 Act reports on Form 10-K or 10-Q. The rule is available notwithstanding delinquencies in filing current reports on Form 8-K.

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Rule 139 is not available for issuer-specific reports concerning any issuer that is or that has been in the past three years a blank check issuer, a shell issuer or a penny stock issuer. The report relying on Rule 139(a)(1) must have been published in the regular course of business by the broker or dealer. Although Rule 139 does not require that the report has been published with "reasonable regularity," the rule will not be available for the initiation (or re-initiation following a discontinuation in coverage) of research. At least one previous report must have been published before Rule 139 will be available. Neither the rule nor the SEC's commentary suggests what would constitute a "discontinuation" in coverage. Rule 139A, a parallel rule for research concerning issuers of asset-backed securities, also does not contain a "reasonable regularity" condition. Rule 139 does not require that the recommendation in a report be no more favorable than in prior reports or that the previously published or distributed report cover the same securities of the issuer that are the subject of the registered offering.

Industry Reports as Covered by Rule 139(a)(2). The inclusion of a reference to an issuer or its securities in a report including "similar information with respect to a substantial number of issuers in the issuer's industry" or a "comprehensive list of securities currently recommended by the broker or dealer" will not be construed as an illegal offer or prospectus, subject to a number of conditions. The issuer in question must be an issuer required to file 1934 Act reports. The disqualifications of blank check issuers, shell issuers and penny stock issuers apply to the same extent as under Rule 139(a).

The issuer under consideration or its securities must be "given no materially greater space or prominence" compared to other issuers or securities included in the report. The protected report must be published in the regular course of business and may not be the first such report by the broker or dealer or the first report following discontinuation of similar reports.

Like Rule 138, Rules 139(b) and (c) provide that reports permitted by the rules will not be considered improper communications in connection with exempt offerings under Rule 144A or Regulation S.

ROADSHOWS

As part of their efforts to market securities, particularly in the case of IPOs and other significant debt and equity offerings, the lead underwriters often organize a "roadshow." A roadshow may be "physical" or "electronic" or both. Organized properly, roadshows should not present a gun jumping problem for a 1933 Act-registered offering or present a problem for the private placement and offshore offering exemptions provided by Section 4(a)(2) and Rule 144A and Regulation S.

Physical Roadshows

Physical roadshows involve a series of meetings at which selected members of the issuer's management make presentations to invited guests, which typically include institutional investors, money managers and securities salespersons. One-on-one meetings

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with significant investors may also be arranged. In the case of 1933 Act-registered offerings, unless the issuer is a WKSI or an EGC, these marketing efforts may begin only after the registration statement has been filed.[67]

Roadshows are permitted in connection with 1933 Act-registered offerings because oral offers may be made once a registration statement is filed. Sufficient quantities of the latest version of the preliminary prospectus should be available at each roadshow presentation, and the preliminary prospectus should be the only written material provided to attendees at the presentation. While information not included in the preliminary prospectus may be presented at a roadshow, the scope and content of such presentations should be cleared with legal counsel before the roadshow begins and is generally limited to information contained in or derivable from the offering documents.

Electronic Roadshows

Electronic roadshows, sales presentations for securities offerings transmitted by means of the Internet, have become commonplace since the SEC first acquiesced to the practice in no-action correspondence beginning in 1997.

For purposes of Rule 164 and Rule 433 under the 1933 Act, 1933 Act-registered offering roadshows transmitted electronically are included within the definition of written communications and therefore constitute free writing prospectuses and are therefore part of the disclosure package. Live transmissions in real time of roadshows to a live audience are treated only as oral communications and are not free writing prospectuses, nor are accompanying visual aids, unless provided in a separate file designed to be available to be copied or downloaded separately.

SEC Filing Requirements

In the case of a 1933 Act-registered offering, electronic roadshows that constitute written communications must be filed with the SEC if the issuer is not required to file 1934 Act reports at the time the registration statement is filed (*i.e.*, an IPO) and the issuer does not make at least one *bona fide* version of a roadshow, covering the same general areas regarding the issuer, its management, and the securities offered as other versions of the roadshow, available to any person without restriction through a graphic communication, such as an openly accessible Internet posting.

Rule 433(e)(1) provides that any information included on an issuer's web site or hyperlinked from a third-party web site will be subject to the filing rules applicable to a free

[67] It is important to note that, although a WKSI may make offers prior to the filing of a registration statement under the 1933 Act, the SEC in 2009 proposed to amend Rule 163 of the 1933 Act to allow a WKSI to authorize an underwriter or dealer to act as its agent in communicating about offers prior to the filing of a registration statement under the 1933 Act. See SEC Release No. 33-9098 (December 18, 2009) (http://www.sec.gov/rules/proposed/2009/33-9098.pdf).

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writing prospectus if the information constitutes an offer and if the information is not otherwise exempt from filing.

Whether treated as an oral or written communication and whether or not required to be filed, an electronic roadshow will be considered part of the issuer's disclosure package for purposes of 1933 Act liability.

STABILIZATION AND REGULATION M[68]

It is a basic premise of the U.S. securities laws that securities should not be distributed in a market that has been stimulated by the activities of persons having an interest in the distribution. In order to ensure that securities are distributed in a market free from manipulation, the SEC adopted Regulation M,[69] which prohibits certain activities in connection with a securities offering.

Regulation M consists of six rules. Rule 100 sets forth applicable definitions. Rules 101 through 105 are collectively intended to prevent persons having an interest in an offering (*i.e.*, the issuer, the underwriters, selling securityholders and certain other parties) from conditioning the market in order to facilitate the distribution. The general prohibitions of the rules are subject to various exceptions that are designed to permit an orderly distribution of securities and limit disruption of the market for the securities in distribution. When a portion of an international distribution is made in the United States, the SEC takes the position that Regulation M has extraterritorial effect, applying not only to the U.S. portion of the distribution but also to the distribution of securities outside the United States.

Restrictions on the Activities of Issuers, Selling Securityholders and Their Affiliated Purchasers

Rule 102 of Regulation M governs the activities of an issuer or selling securityholder during a distribution[70] effected by it or on its behalf, as well as the activities of certain parties deemed to be "affiliated purchasers" of the issuer or selling securityholder. In general, Rule 102 prohibits persons subject to the rule from directly or indirectly bidding for, purchasing or attempting to induce any person to bid for or purchase, the security that is the

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[68] This section contains a summary of Regulation M. The full text of Regulation M may be found at 17 C.F.R Section 242.100, et seq (http://www.gpo.gov/fdsys/pkg/CFR-2012-title17-vol3/xml/CFR-2012-title17-vol3-sec242-100.xml).

[69] See SEC Release No. 34-38067 (Dec. 20, 1996) (http://www.sec.gov/rules/final/34-38067.txt).

[70] For purposes of Regulation M, a "distribution" is defined as an offering of securities that is distinguished from ordinary trading transactions by both (i) the magnitude of the offering and (ii) the presence of special selling efforts and selling methods. In the case of a shelf registration, each individual offering from the shelf would be individually examined to determine whether the elements of a distribution were present (*i.e.*, depending upon the magnitude of the particular offering and the existence of special selling efforts and selling methods). Shelf registrations are discussed at length in Chapter 5 (*Shelf Registration*).

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subject of the distribution ("subject security"), and any security into which the subject security may be converted, exchanged or exercised, or which, under the terms of the subject security, may in whole or in significant part determine the value of the subject security ("reference security"), during the applicable restricted period.[71]

The commencement of the restricted period to which an issuer or selling securityholder and its affiliated purchasers are subject depends upon the nature of the distribution and the characteristics of the particular security. In the case of a distribution involving a merger, acquisition or exchange offer, the restricted period begins on the day proxy solicitation or offering materials are first disseminated to the target company's securityholders. In other distributions, the commencement of the restricted period depends upon the worldwide average daily trading volume ("ADTV")[72] value of the particular security, as well as the public float value of the issuer's securities. For securities with an ADTV value of $100,000 or more of an issuer whose common equity securities have a public float value of $25 million or more, the restricted period will commence one business day[73] prior to the pricing of the subject security. For all other securities, the restricted period will begin five business days prior to the pricing of the subject security. In all cases, the restricted period continues until the distribution is completed.[74]

Certain types of securities are excepted from the prohibitions of Rule 102. This means that persons subject to Rule 102 may continue their trading activities in these securities without regard to the restrictions and limitations otherwise imposed by the rule. These securities are: (i) non-convertible debt and preferred securities, as well as asset-backed securities, that are in each case rated investment grade by at least one nationally recognized statistical rating organization ("NRSRO"); (ii) "exempted securities," as defined in Section 3(a)(12) of the 1934 Act; (iii) face-amount certificates issued by a face-amount certificate company and redeemable securities issued by an open-end management investment company or unit investment trust; and (iv) "actively traded reference securities"

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[71] For example, in a distribution of warrants to purchase common stock, Rule 102 would restrict bids for, purchases of and inducements to bid for or purchase, both the warrants (the subject security) and the underlying common stock (the reference security). In contrast, the rule does not restrict activity with respect to a derivative security (*e.g.*, an option or warrant) during a distribution of the underlying security.

[72] ADTV is defined in Rule 100 of Regulation M as "the worldwide average daily trading volume during the two full calendar months immediately preceding, or any 60 consecutive calendar days ending within the ten calendar days preceding, the filing of the registration statement or, if there is no registration statement or if the distribution involves the sale of securities on a delayed basis pursuant to [Rule 415 under the 1933 Act]," the pricing of the security.

[73] "Business day" is defined in Rule 100 of Regulation M as "a 24-hour period determined with reference to the principal market for the securities to be distributed, and that includes a complete trading session for that market."

[74] In the case of a merger, acquisition, or exchange offer, the distribution will be deemed to be completed after all valuation and shareholder election periods have ended.

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(*i.e.*, reference securities with an ADTV value of at least $1 million issued by an issuer whose common equity securities have a public float value of at least $150 million), provided that the reference securities are not issued by the issuer of the security in distribution, or by any affiliate of the issuer.

Rule 102 also excepts various activities from the general prohibitions of the rule. This means that the issuer or selling securityholder and its affiliated purchasers may engage in these activities during the restricted period. Among other things, the rule excepts (i) odd-lot transactions, (ii) exercises of options, warrants, rights or conversion privileges, (iii) certain unsolicited purchases and (iv) transactions in Rule 144A securities.[75] The exception for transactions in securities eligible for resale under Rule 144A permits transactions in Rule 144A securities during a distribution of such securities, provided that offers and sales of such securities within the United States are made solely to: (i) QIBs, or to persons reasonably believed to be QIBs, in transactions exempt from registration under the 1933 Act;[76] or (ii) persons not deemed to be "U.S. persons" for purposes of Regulation S, during a concurrent Rule 144A distribution to QIBs. The exception covers both the Rule 144A security in distribution and any reference security.

Restrictions on the Activities of Distribution Participants and Their Affiliated Purchasers

Rule 101 under Regulation M governs the activities of persons participating in a distribution of securities, other than the issuer or selling securityholder (*e.g.*, underwriters and prospective underwriters). The rule also governs the activities of any "affiliated purchaser" of the distribution participants. As with Rule 102, Rule 101 prohibits persons subject to the rule from directly or indirectly bidding for, purchasing or attempting to induce any person to bid for or purchase, the subject security or any reference security during the applicable restricted period.

As with Rule 102, the restricted period to which a distribution participant and its affiliated purchasers are subject depends upon the nature of the distribution, as well as the characteristics of the particular security involved. For distributions involving a merger, acquisition or exchange offer, the restricted period will (as under Rule 102) begin on the day proxy solicitation or offering materials are first disseminated to the target company's securityholders and continue until such time as all valuation and shareholder election periods have ended. In traditional capital-raising distributions, the commencement of the restricted period keys off of the pricing of the offering. In some cases the restricted period to which an underwriter or other distribution participant is subject under Rule 101 may be shorter than the

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[75] Offerings pursuant to Rule 144A under the 1933 Act are discussed in detail in Chapter 8 (*Exempt Offerings and Securities*).

[76] This includes offshore offerings exempt from registration pursuant to Regulation S, as well as private placements in the United States exempt from registration pursuant to Section 4(a)(2) of the 1933 Act or Rule 144A or Regulation D thereunder.

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restricted period to which issuer or selling securityholder is subject under Rule 102. In still other cases, an underwriter or distribution participant may not be subject to any restricted period under Rule 101.

In the case of "actively-traded securities" (*i.e.*, securities with an ADTV value of at least $1 million that are issued by an issuer whose common equity securities have a public float value of at least $150 million), and provided the securities are not issued by the underwriter or any affiliate of the underwriter, there is no restricted period under Rule 101. In the event the foregoing exception is not available, but the securities have an ADTV value of at least $100,000 and are issued by an issuer whose common equity securities have a public float value of at least $25 million, the underwriter will be restricted beginning on the *later of* one business day prior to the pricing of the subject security, or such time as the underwriter becomes a distribution participant. For all other securities, the restricted period for an underwriter will begin on the *later of* five business days prior to the pricing of the subject security or such time as the underwriter becomes a distribution participant. The restricted period for an underwriter will continue until the underwriter has distributed its allotment and any stabilization arrangements and trading restrictions in connection with the distribution have been terminated.[77]

As with Rule 102, Rule 101 excepts certain securities from the restrictions of the rule. These securities include the same securities excepted from Rule 102, other than the "actively traded securities" exception mentioned above with respect to Rule 101 and the "actively traded reference securities" exception mentioned under the description of Rule 102 above.

Although many of the provisions of Rule 101 are substantially analogous to those of Rule 102, Rule 101 contains certain additional activity-based exceptions intended to accommodate distribution participants' significant role in the marketplace and their comparatively lesser interest in manipulating an offering. As with 102, Rule 101 includes exceptions for (i) odd-lot transactions, (ii) exercises of options, warrants, rights or conversion privileges, (iii) certain unsolicited purchases and (iv) Rule 144A transactions. Rule 101 also contains exceptions for unsolicited brokerage transactions, the publication or dissemination of research in compliance with Rules 138 or 139 under the 1933 Act, transactions in certain "baskets" of securities, certain *de minimis* transactions, NASDAQ passive market-making activities in compliance with Rule 103 of Regulation M, and stabilizing transactions in compliance with Rule 104 of Regulation M.

Affiliated Purchasers of Issuers, Selling Securityholders and Distribution Participants

For purposes of Regulation M, any person acting in concert with a distribution participant, issuer or selling securityholder in connection with the acquisition or distribution

[77] An underwriter will not be deemed to have completed its participation if a syndicate overallotment option is exercised in an amount in excess of the net syndicate short position at the time of such exercise.

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of a subject security or reference security, and any affiliate (including a separately identifiable department or division) of a distribution participant, issuer or selling securityholder that directly or indirectly controls such person's purchases of a subject security or reference security, whose purchases are controlled by such person, or whose purchases are under common control with such person, is deemed to be an "affiliated purchaser." In addition, any affiliate (including a separately identifiable department or division) of a distribution participant, issuer or selling securityholder that regularly purchases securities for its own account or the account of others, or that recommends or exercises investment discretion with respect to the purchase or sale of securities (a "financial services affiliate"), is deemed to be an "affiliated purchaser" of the entity with which it is affiliated. An affiliated purchaser is restricted in the same manner as the distribution participant, issuer or selling securityholder with which it is affiliated.[78]

Certain financial services affiliates of a distribution participant, issuer or selling securityholder may, however, be excepted from the "affiliated purchaser" definition, and thereby avoid the restrictions otherwise imposed by Rules 101 and 102, provided certain conditions are satisfied. As a preliminary matter, the financial services affiliate may not, during the applicable restricted period, act as a market maker (other than as a specialist in compliance with the rules of a national securities exchange), or engage as a broker or a dealer in solicited transactions or proprietary trading, in a subject security or reference security. This effectively means that any affiliate engaged in these activities will be deemed to be an affiliated purchaser, regardless of whether the remaining conditions of the exception are satisfied. The second condition of the exception requires that the distribution participant, issuer or selling securityholder maintain and enforce written policies and procedures reasonably designed to prevent the flow of information to or from the financial services affiliate that might result in a violation of Regulation M. The distribution participant, issuer or selling securityholder must also obtain an annual, independent assessment of the operation of such policies and procedures. The third and final condition to the exception requires that the financial services affiliate have no officers or employees (other than clerical, ministerial or support personnel) in common with the distribution participant, issuer or selling securityholder that direct, effect or recommend transactions in securities for either entity.

NASDAQ Passive Market Making

In connection with the distribution of a security authorized for quotation on NASDAQ (a "NASDAQ security"), Rule 103 of Regulation M permits an underwriter that is a registered NASDAQ market maker to engage in passive market-making transactions on NASDAQ during the restricted period of Rule 101 when market making by the underwriter

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[78] Thus, an affiliated purchaser of a distribution participant is subject to Rule 101 of Regulation M and an affiliated purchaser of an issuer or selling securityholder is subject to the restrictions of Rule 102. The one exception to this is when an affiliated purchaser of an issuer or selling securityholder is also acting as an underwriter or other distribution participant in connection with the offering. In that case, the affiliated purchaser of the issuer or selling security holder may comply with Rule 101.

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would otherwise be prohibited. The purpose of the rule is to address liquidity problems that might otherwise occur during the distribution of a NASDAQ security if underwriters or their affiliates who are NASDAQ market makers in the security were required to withdraw as market makers during the restricted period. The exception afforded by the rule is not available during any at-the-market or best efforts offering, nor is the exception available for any security for any time in which a stabilizing bid is in effect.

Assuming the exception is available, Rule 103 generally limits the passive market maker's bids and purchases to the highest current independent bid (*i.e.*, the bid of a NASDAQ market maker who is not participating in the distribution). In addition, the rule limits a passive market maker's net purchases of the security on any given day during the restricted period to the greater of: (i) 30% of the market maker's ADTV in the security or (ii) 200 shares. The rule also prohibits the passive market maker from displaying a bid size in excess of the minimum quotation size for the security, as determined by NASDAQ rules, or the passive market maker's remaining purchasing capacity for the day, whichever is less, except that a passive market maker whose purchasing capacity is below 100 shares may display a bid size of 100 shares. Finally, the rule requires that the passive market maker notify FINRA in advance of its intention to engage in passive market making, and the prospectus for any registered offering in which any passive market maker intends to effect transactions in a subject security or reference security must disclose information relating to the passive market-making activity.

Stabilizing Transactions

Rule 104 of Regulation M governs stabilizing and certain aftermarket syndicate activities in connection with an offering of securities, and requires that all persons engaged in these activities follow the conditions of the rule. Although activity in compliance with the rule's conditions is an excepted activity under Rule 101, the rule also applies to persons and offerings that may not be subject to Rule 101 (*e.g.*, the rule applies to offerings that do not satisfy the "magnitude" and "special selling efforts and selling methods" elements of a distribution).

Stabilizing is defined in Rule 100 of Regulation M as "the placing of any bid, or the effecting of any purchase, for the purpose of pegging, fixing or maintaining the price of a security." Rule 104 prohibits all stabilizing in connection with at-the-market offerings, and limits stabilizing bids and purchases in other offerings to those necessary to prevent or retard a decline in the market price of a security. In the U.S. capital markets, stabilizing transactions are typically effected exclusively by the lead or managing underwriter, and the lead or managing underwriter usually reserves the right to stabilize on behalf of all the members of the underwriting syndicate.

As a general matter, Rule 104 requires that priority be given by any person stabilizing to independent bids at the same price, regardless of the size of the bid at the time that it is entered. The rule also provides that no sole distributor, syndicate or group may maintain more than one stabilizing bid in any one market at the same price at the same time. Rule 104

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also imposes numerous conditions upon the price and manner in which stabilizing bids and purchases are initiated and maintained:

(a) Maximum stabilizing price permitted under the rule. Regardless of the following provisions, the maximum price at which stabilizing is permitted under the rule is the *lower of*: (1) the offering price of the security or (2) the stabilizing bid for the security in the principal market when the principal market is open or, when the principle market is closed, the stabilizing bid in the principal market at its previous close.

(b) Initiation when the principal market is open. After the opening of quotations for the security in the principal market, stabilizing may be initiated in any market at a price no higher than the last independent transaction price for the security in the principal market if (1) the security has traded in the principal market on the day stabilizing is initiated or on the most recent prior day of trading in the principal market and (2) the current asked price in the principal market is equal to or greater than the last independent transaction price.[79]

(c) Initiation when the principal market is closed. Immediately before the opening of quotations for the security in the market where stabilizing will be initiated, stabilizing may be initiated at a price no higher than the *lower of*: (i) the price at which stabilizing could have been initiated in the principal market for the security at its previous close or (ii) the most recent price at which an independent transaction in the security has been effected in any market since the close of the principal market. After the opening of quotations in the market in which stabilizing is to be initiated, stabilizing may be initiated at a price no higher than the *lower of*: (i) the price at which stabilization could have been initiated in the principal market for the security at its previous close or (ii) the last independent transaction price for the security in that market, if the security has traded in that market on the day stabilizing is initiated, or on the last preceding business day, and the current asked price in that market is equal to or greater than the last independent transaction price.[80]

(d) Initiation when there is no market for the security. If no *bona fide* market for the subject security exists at the time stabilizing is initiated, no stabilizing shall be initiated at a price in excess of the offering price.

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[79] If both of the foregoing conditions are not satisfied, stabilizing may be initiated in any market after the opening of quotations in the principal market at a price no higher than the highest current independent bid for the security in the principal market.

[80] If both of these conditions are not satisfied, stabilizing may be initiated at a price no higher than the highest current independent bid for the security in the market where stabilizing is being effected.

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(e) Initiating prior to determination of the offering price. If stabilizing is initiated prior to the determination of the offering price, stabilizing may be continued after determination of the offering price at the price at which stabilizing then could be initiated.

(f) Maintenance and carrying over of a stabilizing bid. Once initiated, a stabilizing bid which has not been discontinued may be maintained, or carried over into another market, regardless of changes in the independent bids or transaction prices for the security.

(g) Increasing, reducing and resuming a stabilizing bid. A stabilizing bid may be increased to a price no higher than the highest current independent bid for the security in the principal market if the principal market is open. If the principal market is closed, a stabilizing bid may be increased to a price no higher than the highest independent bid in the principal market at that market's previous close. A stabilizing bid may be reduced, or carried over into another market at a reduced price, regardless of changes in the independent bids or transaction prices for the security. Once discontinued, a stabilizing bid may not be resumed at a price higher than the price at which stabilizing then could be initiated.

(h) Adjustments to reflect exchange rates. If a stabilizing bid is expressed in a currency other than the currency of the principal market for the security, such bid may be initiated, maintained or adjusted to reflect the current exchange rate, consistent with the provisions of the rule.[81]

(i) Adjustments to reflect ex-dividend, ex-rights or ex-distribution. If a security begins to trade ex-dividend, ex-rights or ex-distribution, the stabilizing bid must be reduced by an amount equal to the value of the dividend, right or distribution.[82]

(j) Stabilizing of components. If two or more securities are offered as a unit, the component securities may not be stabilized at prices the sum of which exceeds the then permissible stabilizing price for the unit.

Paragraph (g) of Rule 104 provides that certain offshore stabilizing transactions intended to facilitate an offering in the United States will not be deemed to violate Rule 104 if no stabilizing is effected in the United States, stabilizing outside the United States is effected in a jurisdiction with statutory or regulatory provisions governing stabilizing that are comparable to the provisions of Rule 104 (as determined by the SEC pursuant to rule,

[81] If adjusting the bid in this manner causes the bid to be at or below the midpoint between two trading differentials, the rule requires the stabilizing bid to be adjusted downward to the lower differential.

[82] See *supra* note 70.

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regulation or order)[83] and no stabilizing is effected at a price above the offering price in the United States, except to the extent permitted under Rule 104 to reflect the current exchange rate.

Rule 104 also imposes certain notification, disclosure and record keeping requirements upon persons subject to the rule. Any person intending to display or transmit a stabilizing bid is required to provide prior notice to the market on which such bid will be effected. The person must disclose the bid's purpose to the person with whom the bid is entered. In addition, any person effecting a syndicate covering transaction[84] or imposing a penalty bid[85] is required to provide prior notice to the self-regulatory organization with direct authority over the principal market in the United States for the security for which the syndicate covering transaction is effected or the penalty bid is imposed. The rule further requires any person subject to the rule who sells, or purchases for the account of another, a security that has been or may be stabilized, to deliver to the purchaser at or before the completion of the transaction a prospectus, offering circular, confirmation or other document containing a statement indicating that the underwriter may effect stabilizing transactions in connection with the offering of securities. Finally, persons subject to Rule 104 must keep such information and make such notifications as are required by Rule 17a-2 under the 1934 Act.

In the event of pre-effective stabilization, where stabilization is initiated before the offering price is determined, Item 508(l)(2) of Regulation S-K requires disclosure in the prospectus of the amount of securities bought, the prices at which they were bought and the period within which they were bought. In the case of an offering pursuant to Rule 430A, the prospectus must set forth information on the stabilizing transactions that took place before the determination of the public offering price.

"Exempted securities," as defined in Section 3(a)(12) of the 1934 Act, are excepted from the conditions and limitations of Rule 104. The rule also excepts securities eligible for resale under Rule 144A, provided that the Rule 144A-eligible securities are offered or sold in the United States solely to (i) QIBs, or persons reasonably believed to be QIBs, in a transaction exempt from registration under the 1933 Act or (ii) persons not deemed to be "U.S. persons" for purposes of Regulation S, during a concurrent Rule 144A distribution to QIBs.

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[83] For purposes of this provision, the SEC currently recognizes the stabilization regulations of the U.K. Financial Services Authority.

[84] Defined in Regulation M as the placing of any bid or the effecting of any purchase on behalf of the sole distributor or the underwriting syndicate or group to reduce a short position created in connection with the offering.

[85] Defined in Regulation M as an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.

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Short Selling in Connection with a Public Offering

Whereas Rules 101 through 104 of Regulation M generally govern the activities of the issuer, selling securityholders, underwriters and other distribution participants (as well as their respective affiliated purchasers), Rule 105 of Regulation M currently governs an investor's right to receive an allocation of equity securities in certain U.S. public offerings if the investor sold the offered securities short in the days immediately preceding pricing.[86]

Rule 105 applies only to offerings that meet all of the following criteria: (i) the offering is for "equity securities," as defined under the 1934 Act (note that this includes preferred securities, as well as convertible debt securities; by contrast, offerings of "straight debt," whether or not rated investment grade, are excluded); (ii) the offering is conducted on a firm-commitment basis (*i.e.*, the rule does not apply to "best efforts" or contingent offerings); and (iii) the offering is either a SEC registered offering for cash or a Regulation A or E offering for cash (*i.e.*, the rule does not apply to private placements, including Rule 144A sales). In this regard, Rule 105 applies to a somewhat different universe of offerings than do Rules 101 and 102 of Regulation M. While Rule 105 only applies to certain public offerings, the rule's application is not confined to those public offerings that rise to the level of a Regulation M "distribution."[87]

For those offerings subject to Rule 105, an investor may not purchase the offering shares if the investor effected any "short sales" of the securities that are the subject of the offering during the rule's "restricted period," unless the investor is able to claim one of the rule's exceptions.

Importantly, the Rule 105 "restricted period" is calculated independently of the "restricted period" applicable to Rules 101 and 102 of Regulation M (discussed above). The Rule 105 restricted period is the *shorter of* (i) the period commencing five business days prior to the pricing of the offering and ending with such pricing or (ii) the period commencing with the initial filing of the registration statement (or a notification on Forms 1-A or 1-E) and ending with the pricing.

There are three separate and distinct exceptions to Rule 105's general prohibition. An investor who sold the subject securities short during the rule's restricted period may still purchase in the offering if it is able to satisfy one of these exceptions, each of which imposes

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[86] Rule 105 was significantly amended effective October 9, 2007. See SEC Release No. 34-56206 (Aug. 6, 2007) (http://www.sec.gov/rules/final/2007/34-56206.pdf). Previously, Rule 105 generally prohibited investors from using offering shares to cover a short sale of a security if they effected any short sales of the security in the days immediately preceding the pricing of the offering—the prohibited activity was the "covering" of the short sales, not the receiving of the allocation. Effective as of October 9, 2007, the amended rule does not focus upon how the offering shares are used. Rather, the amended rule generally prohibits receipt by an investor of an allocation if the investor sold the security short in the days immediately preceding pricing unless the investor is eligible to claim one of the rule's exceptions.

[87] See *supra* note 70 for Regulation M's definition of "distribution."

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a number of specific conditions and limitations: (i) the *bona fide* purchase exception; (ii) the separate accounts exception; and (iii) the investment company exception. A general summary of these exceptions is set forth below.

Bona Fide Purchase Exception. An investor may still receive an allocation in the offering if it makes one or more *bona fide* purchase(s) of the security. Among other things, such *bona fide* purchase(s) must: (i) all be reported trades and take place after the last of the investor's Rule 105 restricted period short sales; (ii) be at least equivalent to the aggregate amount of the investor's Rule 105 restricted period short sale(s); and (iii) be completed no later than the business day prior to the day of pricing.[88]

Separate Accounts Exception. The separate accounts exception allows a person to purchase offered securities in one account where there was a short sale in another, separate account if decisions regarding securities transactions for each account are made separately and without any coordination of trading or cooperation among or between the accounts (in other words, one account is not "tainted" by the short selling activity of the other account). This exception is of course not available where the account seeking the allocation has also sold the security short during the Rule 105 restricted period.

Investment Company Exception. Under this exception, a registered investment company (or any series of such investment company), may purchase an offered security even if a separate series of that same investment company, or an affiliated investment company (including a series of such affiliated investment company), sold the security short during the Rule 105 restricted period. The exception is similar in principle to the "separate accounts" exception but relies upon existing regulations under the 1940 Act and prohibitions to ensure the "separateness" and lack of coordination between or among the funds (or series).

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[88] See *supra* note 73 for the definition of "business day." In the SEC release adopting the current version of Rule 105, the SEC further clarifies that the purpose of this latter requirement is to ensure that there is, in essence, a "cooling off period" of one full trading session between the time when the *bona fide* purchase activity is completed and the time of pricing. Specifically, the SEC explains that "[t]he element that the *bona fide* purchase occur no later than the business day prior to the day of pricing also allows an opportunity for market reaction prior to pricing an offering. For example, if an offering is priced on Wednesday after the close of regular trading hours, the *bona fide* purchase could not be made during regular trading on Wednesday." See SEC Release No. 34-56206 (Aug. 6, 2007) (http://www.sec.gov/rules/final/2007/34-56206.pdf).

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CHAPTER 2

PRE-OFFERING MATTERS

GENERAL 71
PREPARING THE TEAM 71
PREPARING THE BUSINESS PROFILE 72
EGC STATUS AND BENEFITS 73
SELECTING A JURISDICTION OF INCORPORATION 73
PREPARING THE CORPORATE ENTITY 74
THE COVENANT STRUCTURE FOR DEBT OFFERINGS 76
THE 1940 ACT 76
ACCOUNTING MATTERS 77

GENERAL

An issuer that has decided to offer securities in the capital markets must prepare its team for the legal, regulatory and market practice issues that lie ahead, some of which may require the issuer to take corporate action in anticipation of its securities offering. Discussed in this chapter are some preliminary matters that should be addressed by an issuer to ensure that it is prepared for its first offering in the capital markets.

Given the broad range of securities that issuers may choose to offer to raise capital and funding in the capital markets, and the different ways of offering securities in compliance with the 1933 Act, it is hard to generalize about the matters addressed in this chapter. As noted in Chapter 1 (*The Offering Process*), in certain instances, such as bank certificates of deposit issued by U.S. banks, commercial paper and extendible notes, the offering documents contain little disclosure and the transaction documents are relatively standard, so the amount of time and effort needed to offer and sell those securities in the U.S. capital markets should be relatively short and easy. At the other end of the spectrum, an issuer's first offering of 1933 Act-registered securities or securities offered on a Rule 144A basis with full disclosure is a significant exercise.[89]

PREPARING THE TEAM

A securities offering requires a cooperative relationship among the issuer, the issuer's auditor, the securities firms[90] that will be selling the issuer's securities and their respective

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[89] See *Accessing the U.S. Capital Markets – Securities Products*, which provides a detailed analysis of pre-offering matters that are most relevant in this instance.

[90] As sellers of an issuer's securities, securities firms may act in varying capacities including firm-commitment underwriters, best-efforts underwriters, selling agents and brokers. Their role in any particular (continued)

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legal advisers. Many issuers accessing the capital markets for the first time have previously only borrowed money from banks, governments and supranational organizations and, in the case of businesses, raised equity capital from private investors. These first-time issuers are accustomed to negotiated transactions and the absence of the investor protections that would otherwise be afforded by securities laws and regulations. The market-driven pricing and disclosure-based liabilities that are (to varying degrees) part of every securities offering require the relationships among all parties to be largely cooperative, not adversarial.

Officers of an issuer accustomed to establishing the terms of a financing in a privately negotiated transaction or with the benefit of an exemption from U.S. securities laws should rely upon the issuer's professional advisers' assistance to understand the requirements of regulatory schemes designed to protect investors and market practices. An issuer must be prepared for the amount of work required for its first U.S. securities offering and the importance of adhering to the agreed timetable, as well as complying with the ongoing reporting and regulatory requirements that may result, particularly in the case of a 1933 Act-registered offering.[91] For issuers accessing the U.S. capital markets for the first time, it is important to note that, with the experience they gain from their first U.S. securities offering, additional U.S. securities offerings will be significantly easier and less expensive.

PREPARING THE BUSINESS PROFILE

To facilitate its offering, an issuer that is raising funds in the U.S. capital markets for the first time may be advised by securities firms to refine its business profile and its business strategy, and may be required to establish appropriate corporate governance and legal compliance procedures. In the case of a 1933 Act-registered offering, the issuer should consider whether it is an EGC, which would provide certain reduced disclosure and other benefits. See "*EGC Status and Benefits*" below. An issuer may also effect a number of pre-offering transactions to appropriately reorganize its corporate structure.

When accessing the capital markets for project or infrastructure financing, a sponsor will normally form a special-purpose company to develop, construct, finance and operate the project. Under this approach, all tangible and intangible assets associated with the project are transferred to the special-purpose company, and pledged or mortgaged to investors (in the case of debt securities), with no recourse (or only limited recourse, on terms to be agreed upon) to the assets of the sponsor. Because their return will be directly dependent upon the business developed by the special-purpose company to which they have contributed, investors can be expected to closely scrutinize the development and operation of the business of this type of company.

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transaction will depend upon a combination of the needs of the transaction and the customary practice in the segment of the capital markets that the issuer intends to access.

[91] For a discussion of ongoing reporting requirements for 1933 Act-registered offerings, see Chapter 3 (*The Securities Registration and Reporting Process*).

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EGC STATUS AND BENEFITS

An issuer should determine whether it qualifies as an EGC. To qualify as an EGC, an issuer for its most recently completed fiscal year must have had a total gross revenue of less than $1 billion. As noted in the Introduction (*An Overview of U.S. Securities Regulators and Laws*), the JOBS Act changes numerous compliance obligations and provisions of Sarbanes-Oxley, Dodd-Frank and other federal securities laws and regulations as they apply to EGCs. EGCs initially have a reduced compliance burden and are able to market their securities with increased flexibility. For example, the JOBS Act permits EGCs to:

- "test-the-waters" without breaching well-established gun-jumping rules;
- file a registration statement for confidential review with the SEC;
- include only two years of audited financial statements in its IPO registration statement and prospectus;
- provide only two years of summary financial disclosure; and
- include reduced MD&A and executive compensation disclosure in an IPO registration statement and prospectus.

An issuer should continually monitor and be cognizant of the ways of losing its EGC status, including, but not limited to, exceeding $1 billion in gross revenue, selling more than $1 billion in non-convertible bonds over a three-year period, or becoming a large accelerated filer.

SELECTING A JURISDICTION OF INCORPORATION

Private companies are often organized under the laws of the state in which their principal place of business is located. Prior to going public or undertaking a Rule 144A offering, many companies choose to reincorporate in Delaware. Delaware tends to be the jurisdiction of choice for public companies, both because its corporation laws are revised on an ongoing basis to address evolving business practices, and also because Delaware has an exceptionally rich body of case law and a judiciary that regularly hears cases, concerning mergers, acquisitions and other corporate and business matters. A common exception relates to real estate investment trusts ("REITs"), which typically incorporate in Maryland due in part to the state's lower franchise taxes.[92] Also, private companies with substantial operations outside the United States may also want to consider reincorporating their domicile to a more appropriate international jurisdiction.

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[92] REITs are discussed in detail in Chapter 11 (*REITs*).

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PREPARING THE CORPORATE ENTITY

Issuers offering securities in the U.S. capital markets, particularly those registering securities under the 1933 Act for the first time, may be required to modify their corporate structure, governance practices, legal documentation and accounting procedures in order to meet the standards required by the SEC, federal and state securities laws, applicable securities exchanges and investors. Examples of such items include the following:

- An issuer undertaking an equity IPO will need to meet stock exchange and SEC requirements for the independence of both its board of directors and applicable board committees. For example, NYSE and NASDAQ rules require that a majority of the board of directors be independent and also require an audit committee (and one or more additional committees) composed entirely of independent directors. Likewise, pursuant to the requirements of Rule 10A-3 under the 1934 Act, which implements Sarbanes-Oxley, no security is eligible for listing unless each member of the issuer's audit committee is independent. An issuer contemplating an IPO and the lead underwriter should determine at an early stage whether the board of directors and board committees will comply fully with these requirements at the time of the IPO or if the issuer will take advantage of the one year phase-in available under NYSE and NASDAQ rules.[93]

- The issuer may wish to reincorporate in Delaware or another state or effect other changes to its corporate structure, such as establishing a holding company or forming or merging subsidiaries, before the offering.

- Whether or not the issuer chooses to reincorporate in Delaware, it is often necessary to amend and restate the issuer's charter and bylaws or comparable organizational documents prior to its first securities offering. This is particularly true in the case of an IPO, where it may be necessary to remove venture-stage provisions from the charter and bylaws, increase authorized capital stock and add appropriate anti-takeover and indemnification provisions.

- Existing documentation with stockholders and other investors should be reviewed to determine if any modifications are necessary. While many provisions in pre-IPO agreements entered into by an issuer and its initial investors are drafted to terminate automatically at the time of an equity IPO, there may be other provisions that survive the IPO but that may be unacceptable to securities firms or investors.

- Existing undocumented agreements and understandings material to the issuer's business may be required to be documented, and existing documentation may be

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[93] The listing requirements of the NYSE, the NYSE Euronext and NASDAQ are discussed in detail in Chapter 6 (*Listing on U.S. Securities Exchanges*).

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required to be revised in order to provide the degree of specificity and certainty required by investors. For example, if a key purchase or supply contract contains material uncertainties, the issuer may be asked by the securities firms or advised by its lawyers to restate or supplement the contract in order to avoid the marketing or legal risks associated with those uncertainties.

- Existing financing documentation may be required to be revised or provisions thereof waived to accommodate the securities offering, or the issuer may choose to use its intention to access the U.S. capital markets as a basis for negotiating a larger credit facility or more favorable terms with its existing lenders.

- An issuer contemplating an IPO will be required to establish corporate governance practices that comply with the SEC's rules and any applicable stock exchange requirements and may be required to establish or alter its legal compliance or internal audit procedures or take other action in order to list its securities on a U.S. securities exchange, comply with Sarbanes-Oxley or improve the marketability of its securities. An issuer contemplating a pre-IPO Rule 144A offering may also be required, by its advisors or investors, to establish similar policies and procedures.

- It may be desirable for an issuer to enter into employment contracts with key personnel if they are critical to the continued success of its business, or could become significant competitors to the issuer, or both. It is not uncommon for securities firms to request such agreements to enable them to better market the securities of a business that has been started and is currently being managed by one or more private entrepreneurs. In the case of an IPO, it is typical to establish equity compensation plans for management and directors prior to the offering.

- Because, in addition to an issuer itself, executive officers and directors of an issuer are potentially liable when an issuer offers securities in the United States, the issuer should take steps to protect its executive officers and directors from this liability to the extent permitted by the law of the issuer's jurisdiction. Typical sources of protection include the purchase of officers' and directors' liability insurance, indemnity agreements entered into with the issuer and inclusion of appropriate indemnification provisions in the charter and bylaws or similar organizational documents.

- The SEC requires issuers to file electronically through its EDGAR system (available at http://sec.gov), most of their securities documents, including registration statements under the 1933 Act and registration statements, periodic reports and other documents under the 1934 Act. In preparation, issuers must complete and execute the SEC's Form ID to obtain the necessary access codes to file on the EDGAR system. Issuers should also be mindful of the fees associated with 1933 and 1934 Act filings.

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THE COVENANT STRUCTURE FOR DEBT OFFERINGS

In the case of an offering of debt securities, the issuer and the underwriters or agents will need to develop an appropriate covenant package for inclusion in the debt documents.

In the case of investment grade debt securities, covenant packages are generally much less restrictive than covenant packages typically found in bank loan financings for similarly situated issuers. Affirmative covenants usually include limitations on liens and sale and leaseback transactions, and a provision that addresses mergers, consolidations and the sale by the issuer of all or substantially all of its assets.

In the case of debt securities rated below investment grade, the securities will pay a higher coupon (so-called "high-yield" debt), and will contain a more restrictive set of covenants as compared to investment grade debt that, in addition to those referred to above, may include, among other things, limitations on the issuer's (and its subsidiaries') ability to incur additional debt, limitations on the payment of dividends and other restricted payments, and limitations on asset dispositions, transactions with affiliates and the entering into of derivative transactions. High-yield debt issuers and investment grade debt issuers may also be required to offer to repurchase the debt securities under certain circumstances, including most frequently a change in control or in the event of certain asset sales.

High-yield debt covenants are generally subject to extensive negotiation, and vary considerably depending on the financial and business circumstances of the issuer. It is critical (particularly for longer maturity high-yield debt instruments) that an issuer's covenants be tailored to the particular needs of its business, as it is conducted at the time of the offering and likely to develop over the period the securities are outstanding, given that changes to covenants typically require the consent of at least a majority of securityholders. The complexity of these packages is such that the issuer, in consultation with its counsel, must develop a sophisticated compliance strategy. Some high-yield debt offerings, particularly those by issuers financing major expansion programs or other projects, have been secured by assets of the issuer or guarantor.[94]

Investment grade debt offerings by issuers in cyclical industries (such as oil and gas), or in certain other industries (such as real estate investments) may require additional covenants designed to address investors' concerns about the particular circumstances that apply.

THE 1940 ACT

In preparing for a securities offering in the U.S. capital markets, issuers must ensure that they are not required to register as an investment company under the 1940 Act. Because

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[94] *Accessing the U.S. Capital Markets – Securities Products* discusses the covenant packages for high yield debt securities in much greater detail. Chapter 11 (*REITs*) discusses covenant packages for REITs.

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the 1940 Act embodies a broad regulatory scheme intended primarily for mutual funds, unit investment trusts and closed-end investment companies, it contains requirements that are not consistent with the business of a normal operating company. The 1940 Act regulates, among others, each issuer that (i) is engaged in the business of investing, reinvesting or trading securities or holding or owning securities and (ii) owns or proposes to acquire investment securities (exclusive of U.S. federal government securities and cash items) having a value exceeding 40% of the value of the issuer's unconsolidated total assets.[95]

ACCOUNTING MATTERS

An issuer that makes a 1933 Act-registered public offering or a Rule 144A offering of its securities to a broad group of QIBs in the U.S. capital markets must also provide investors with audited annual financial statements and interim financial statements that are appropriate for the type of offering involved. Preparation of the financial statements for an issuer's first U.S. securities offering may therefore affect not only the timing of the offering but also the valuation of the issuer.

Issuers must also be cognizant of Regulation G, which requires public companies that disclose or release "non-GAAP financial measures" (any published statements using financial presentations not conforming to GAAP) to include in that disclosure or release a presentation of the most directly comparable GAAP financial measure, and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure.[96]

Chapter 4 (*Disclosure Requirements*) discusses the financial statement requirements for a 1933 Act-registered offering. Chapter 7 (*Ongoing Reporting and Other Requirements*) discusses the audit, auditor and audit committee requirements of Sarbanes-Oxley.

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[95] The 1940 Act is further discussed in Chapter 9 (*1940 Act-Exempt Issuers*) and Appendix A (Determining whether an Issuer is a Prima Facie Investment Company or Exempt Pursuant to Rule 3a-1 under the Investment Company Act of 1940).

[96] For further information on Regulation G and its requirements, see the discussion under the heading "Disclosure Regarding Non-GAAP Financial Measures" in Chapter 4 (*Disclosure Requirements*).

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SECTION II. REGISTERED PUBLIC OFFERINGS

The process for registering and listing securities and updating 1933 Act-registered programs and shelf registration statements for public offerings in the U.S. capital markets is among the most rigorous in the world and has provided the U.S. capital markets with ample depth and strength. This is attributable not only to the high disclosure and other standards prescribed by the SEC for 1933 Act-registered offerings, but also to the development of the unregistered Rule 144A securities market for QIBs and other sophisticated investors, which has evolved into a market that, for the most part, has disclosure and other standards that closely approximate those established for 1933 Act-registered offerings. Accordingly, Section II should be of equal interest to issuers contemplating accessing the 1933 Act-registered market and those contemplating accessing the unregistered Rule 144A market.

Section II addresses the registration and reporting process of the 1933 Act and the 1934 Act, including the forms used, the filing and information requirements and the special regime that applies to programs and shelf registration. With the adoption in 2005 of Securities Offering Reform, including the establishment of the WKSI category, and subsequent rule making by the SEC,[97] and the adoption of the JOBS Act of 2012, including the establishment of the EGC issuer category and subsequent rule making and interpretation by the SEC,[98] the U.S. Congress and the SEC has continued to focus on increasing the ease of registering a securities offering without compromising the high disclosure standards that exist in the U.S. capital markets.

Section II also addresses the process of listing securities on a U.S. securities exchange.

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[97] See, *e.g.*, SEC Release No. 33-8959 (Sept. 23, 2008) (http://www.sec.gov/rules/final/2008/33-8959.pdf).

[98] See SEC Spotlight on the JOBS Act (http://www.sec.gov/spotlight/jobs-act.shtml)

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CHAPTER 3

THE SECURITIES REGISTRATION AND REPORTING PROCESS

REGISTRATION UNDER THE 1933 ACT 79
THE SECURITIES REGISTRATION PROCESS.. 80
REGISTRATION AND REPORTING UNDER THE 1934 ACT 89

REGISTRATION UNDER THE 1933 ACT

Section 5 of the 1933 Act applies to all offers and sales of securities in the United States. Except for exempt securities and exempt transactions,[99] all lawful offers and sales must be the subject of a 1933 Act registration statement.

In the absence of an exemption, no person may offer securities in the United States unless a 1933 Act registration statement has been filed.[100] No sales of such securities in the United States may be made unless a registration statement is effective. Registration statements become effective upon an order by the SEC or, for certain forms of registration, automatically under the SEC's rules. The most important part of a 1933 Act registration statement is the prospectus, the central disclosure document concerning the issuer and its offering. By its terms, the 1933 Act requires delivery of the prospectus to each purchaser, but the SEC's rules dispense with actual delivery in most offerings if the prospectus is filed with the SEC and available through the Internet.

The particulars of business, financial and other disclosure required in a prospectus will depend on the registration form the issuer uses. These forms include the S-series (which are the forms used by U.S. issuers) and F-series (which are the forms primarily used by foreign private issuers).[101] Under both series, mature reporting issuers may make disclosures through incorporation by reference of 1934 Act reports.

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[99] See Chapter 8 (*Exempt Offerings and Securities*).

[100] An exception applies to certain offers by WKSIs under Rule 163. The recently enacted JOBS Act also allows offers exclusively made to certain institutions before filing a registration statement. New Section 5(d) of the 1933 Act permits such offers for securities of "emerging growth companies," which are generally companies with less than $1 billion revenues that had not made a registered offering before December 2011.

[101] For a detailed discussion of the "F" forms and other forms used by foreign issuers, see Chapter 3 (*The Securities Registration and Reporting Process*) in *Accessing the U.S. Capital Markets – Non-U.S. Issuers*.

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"S" Forms[102]

Any issuer, other than a foreign government, including its political subdivisions, and investment companies required to register under the 1940 Act, may use Form S-1. Form S-1 is the SEC's residual form of 1933 Act registration. For IPOs, the form calls for presentation of all business, financial and offering information to be included in the prospectus. Reporting companies may normally incorporate by reference information from historical 1934 Acts reports. Form S-3, the form most U.S. issuers use in U.S. securities offerings after the IPO, can be used by mature reporting companies and permits the incorporation by reference of both historical and prospective 1934 Act reports, which, under the correct conditions, will allow the issuer to make securities sales at any time in delayed and continuous offerings. Form S-3, instead of requiring the presentation of complete financial and business disclosure in the prospectus, allows incorporation by reference of such disclosure from the issuer's past and future filings on Forms 10-K, 10-Q and 8-K[103] and proxy statements, a feature of the Form S-3 that generally keeps the prospectus current and therefore usable at any time. For WKSIs, Form S-3 is usable as an automatic shelf registration statement, providing the maximum in financing flexibility.

Issuers that register their securities offerings under the 1933 Act on the S forms, whether or not any securities are registered under the 1934 Act must file annual reports including audited annual financial statements on Form 10-K, quarterly reports including unaudited financial statements on Form 10-Q and current reports on specified material developments on Form 8-K. The disclosure requirements for the SEC's S forms and the corresponding 1934 Act reporting forms are taken principally from Regulation S-K, for narrative disclosures, and Regulation S-X, for financial statement form and content.

THE SECURITIES REGISTRATION PROCESS

The registration process for a public offering begins when an issuer and the securities firm or firms underwriting the issuer's securities agree in principle to conduct an offering.

A 1933 Act registration statement must comply with the disclosure requirements of the 1933 Act and SEC regulations. Because the issuer, its directors and certain of its officers, and the underwriters for the offering are exposed to potential liability for untrue or deficient disclosure in a 1933 Act registration statement, including the prospectus, the 1933 Act registration statement must be satisfactory to all these persons. The preparation of a 1933 Act registration statement for a public offering usually includes investigations designed to ensure adequate disclosure and, because the 1933 Act makes reasonable investigation a

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[102] The "S" Forms are available at http://www.sec.gov/about/forms/secforms.htm#1933forms.

[103] "Furnished" 8-K reports are generally not incorporated by reference. See Chapter 4 (*Disclosure Requirements*).

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defense against liability for material misstatements and omissions for persons other than the issuer, to protect those persons from liability, a practice known as "due diligence."[104]

It is impossible to predict with precision how long it will take to prepare a 1933 Act registration statement. A key factor is whether the issuer has previously filed a 1933 Act registration statement or an annual report with the SEC on Form 10-K, or has previously prepared an offering document containing substantially the same information that would be included in a 1933 Act registration statement. Registration statements for IPOs in the United States typically require months from the commencement of preparation until the order of effectiveness from the SEC.

An issuer that has previously filed a 1933 Act registration statement or an annual report on Form 10-K will, of course, understand the preparation of 1933 Act disclosure much better than an inexperienced issuer and ordinarily will need less time working with the underwriters to produce a 1933 Act registration statement containing sufficient disclosure. Indeed, once an issuer has been through the process of registering an offering of securities under the 1933 Act, subsequent offerings in the U.S. capital markets should normally involve much less time and effort.

Plain English Disclosure

With the objective of making prospectuses more readable, the SEC instituted the use of "plain English" writing principles for the front and back cover pages, summary and risk factors sections of prospectuses. These sections should be drafted so that disclosure is easy to read and highlights important information for investors. The rules also require the use of certain writing techniques in the entire prospectus. The use of pictures, logos, charts, graphs and other similar design features is encouraged.

The prospectus as a whole is required to be clear, concise and understandable. The SEC's staff strongly encourages the use of plain English writing techniques in the entire prospectus. In certain highly technical matters such as indenture covenants, or conversion or exchange provisions that apply to offered securities or engineering or other data applicable to an issuer's business, the use of plain English may not be appropriate.[105]

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[104] The due diligence defense is found in Section 11(b) of the 1933 Act. Further information on the defense is included in the discussion under the heading "Due Diligence" in Chapter 1 (*The Offering Process*) and in Chapter 16 (*Liabilities Under U.S. Securities Laws*).

[105] SEC staff commentary and suggestions relating to plain English can be found in the SEC Division of Corporation Finance: Updated Staff Legal Bulletin No. 7 (June 7, 1999) (http://www.sec.gov/interps/legal/cfslb7a.htm).

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Electronic Filing and Fees

The 1933 Act registration statement (including the transaction documentation) is filed with the SEC. A filing fee, if applicable, must be paid to the SEC's account with U.S. Bank, N.A., by wire transfer, certified or cashier's check or eligible money order. The filing fee is calculated pursuant to Section 6(b) of the 1933 Act and can vary from year-to-year. The current fee can be determined from the SEC's annual notice in the Federal Register or from "Fee Rate Advisory" press releases available on the SEC's web site. All registration statements must be in electronic format and filed by means of the SEC's EDGAR system. Issuers also must file in electronic format all letters in response to SEC staff comments on the filing and other related correspondence.[106]

WKSIs using automatic shelf registration statements are eligible for the "pay as you go" system created under the securities offering reform rules. This system permits WKSIs to defer payment of the registration fee until the securities are taken down from the shelf registration.

Staff Review and Comment

For registration statements other than automatic shelf registration statements, which are not subject to review, the SEC staff will normally advise the issuer two to five days after the filing whether the registration statement will be reviewed in whole or in part. If the registration statement is not selected for review, the SEC staff will generally declare the registration statement effective within forty-eight hours after a request to do so.

First-time issuers almost always are fully reviewed. Subsequent 1933 Act registration filings are selected for review on the basis of unannounced standards set by the SEC staff, as well as on a random basis.[107] A filing may also be selected by the SEC staff for a partial review (*e.g.*, limited to the terms of the security being offered or the plan of distribution) or for a review to determine whether the issuer has complied with SEC staff comments on an earlier filing or with recently adopted rules. When the SEC fully reviews a registration statement, it will normally send the issuer its letter of comment approximately thirty days after filing. After responses have been made to the staff's comments, which may entail additional correspondence and the filing of one or more amendments to the registration statement, the SEC staff will, upon request, declare the registration statement effective.

The JOBS Act provides a first-time issuer that qualifies as an EGC with the option to confidentially submit a draft registration statement to the SEC for review. The confidential submissions are not filed registration statements, so that public offerings of securities do not

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[106] As of the date of publication, the fee is $136.40 for each $1 million of securities sold (http://www.sec.gov/news/press/2012/2012-174.htm).

[107] Sarbanes-Oxley requires the SEC to review each issuer's 1934 Act filings at least every three years.

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become legal for purposes of Section 5(c) of the 1933 Act following the submissions until such time as this registration statement is publicly filed under the 1933 Act.

Since October 15, 2012, such submissions must be made on EDGAR.[108] The comment letters from the SEC staff, as well as the issuer's responses will be deemed confidential information and will not be made public on EDGAR until at least twenty business days following the effective date of the registration statement. The submission of a draft registration statement for confidential review is not a "filing" of registration statement; the EGC must publicly file the registration statement on EDGAR at least twenty-one days before the start of its road show or before the anticipated date of effectiveness of the registration statement. At the date of the public filing of the registration statement, the issuer's confidential submission and all amendments thereto must be attached as exhibits to the registration statement. Issuer response letters to SEC staff comments should also be resubmitted on EDGAR when the issuer first file its registration statement. The confidential submission does not need to be signed by officers or directors of the issuer, does not need to include the consent of auditors or other experts, and no filing fees are due until the registration statement is filed on EDGAR. The confidential submission, however, must be substantially complete and must include a signed audit report covering the audited financial statements.

FINRA Review

For certain 1933 Act-registered offerings, a "no objections" letter from FINRA is necessary before the SEC will declare the registration statement effective.[109] Because not all 1933 Act-registered offerings are subject to FINRA review, legal counsel should be consulted before filing.

The purpose of FINRA review is to determine whether, in its prescribed standards, the underwriting arrangements are fair and reasonable to the issuer, an assessment made on the basis of the documents and information required as part of the filing. FINRA's review is undertaken concurrently with the 1933 Act registration process

FINRA review is a routine procedure for most offerings underwritten by major securities firms. Although the issuer will be responsible for the filing fees, the managing underwriter for the offering and its counsel customarily have the responsibility for the filing itself.

All documents that are required to be filed with FINRA under FINRA Rule 5110 must be filed electronically using FINRA's Public Offering System. All filings with FINRA are

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108 See http://www.sec.gov/divisions/corpfin/cfannouncements/drsfilingprocedures101512.htm.

109 Effectiveness of automatic shelf registration statements is not conditional upon FINRA review. Other shelf registration statements are subject to FINRA review. FINRA usually will review these within twenty-four hours of filing.

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confidential. All documents that are filed electronically with the SEC will be treated as if filed with FINRA.[110] If an EGC confidentially submits a draft registration statement to the SEC for review, it should make the required FINRA filings at the same time.

Solicitations of Interest

After the filing of a registration statement and prior to effectiveness, the underwriters are permitted to solicit indications of interest from investors through the distribution of copies of the preliminary prospectus or "red herring" included in the 1933 Act registration statement. This practice informs the pricing process for the issuer and underwriters. When the review process is completed and the SEC staff is prepared to declare the registration statement effective, the underwriters will be in a position to agree with the issuer on the price at which they will purchase the securities from the issuer and resell them to the public.

Under a new Section 5(d) of the 1933 Act, an EGC and its authorized representatives may engage in preliminary oral and written communications with potential investors that are QIBs or institutional accredited investors before, during and after a registration statement is publicly filed with the SEC. These practices are called test-the-waters communications. An issuer that is an EGC when it makes such a communication but that is no longer an EGC at the time of filing a registration statement will not be penalized for such communications. The EGC and the underwriters would still be subject to potential liability under Section 10(b) of the 1934 Act, Section 17 of the 1933 Act and possibly Section 12(a)(2) of the 1933 Act in connection with these activities.

Shelf Registration

To avoid unpredictable delays resulting from the SEC's review process, an issuer eligible to use Form S-3 has the option of registering securities before they are intended for sale and putting them "on the shelf," as discussed in Chapter 5 (*Shelf Registration*). By registering an offering of securities prior to commencement of the offering, shelf registrations greatly enhance the ability of issuers to sell securities in the U.S. capital markets.

Summary Form Eligibility Chart

The following chart summarizes the eligibility requirements for use of the SEC's 1933 Act Forms S-1 and S-3:

[110] The SEC filings are generally available to the public under Securities Act Rule 120.

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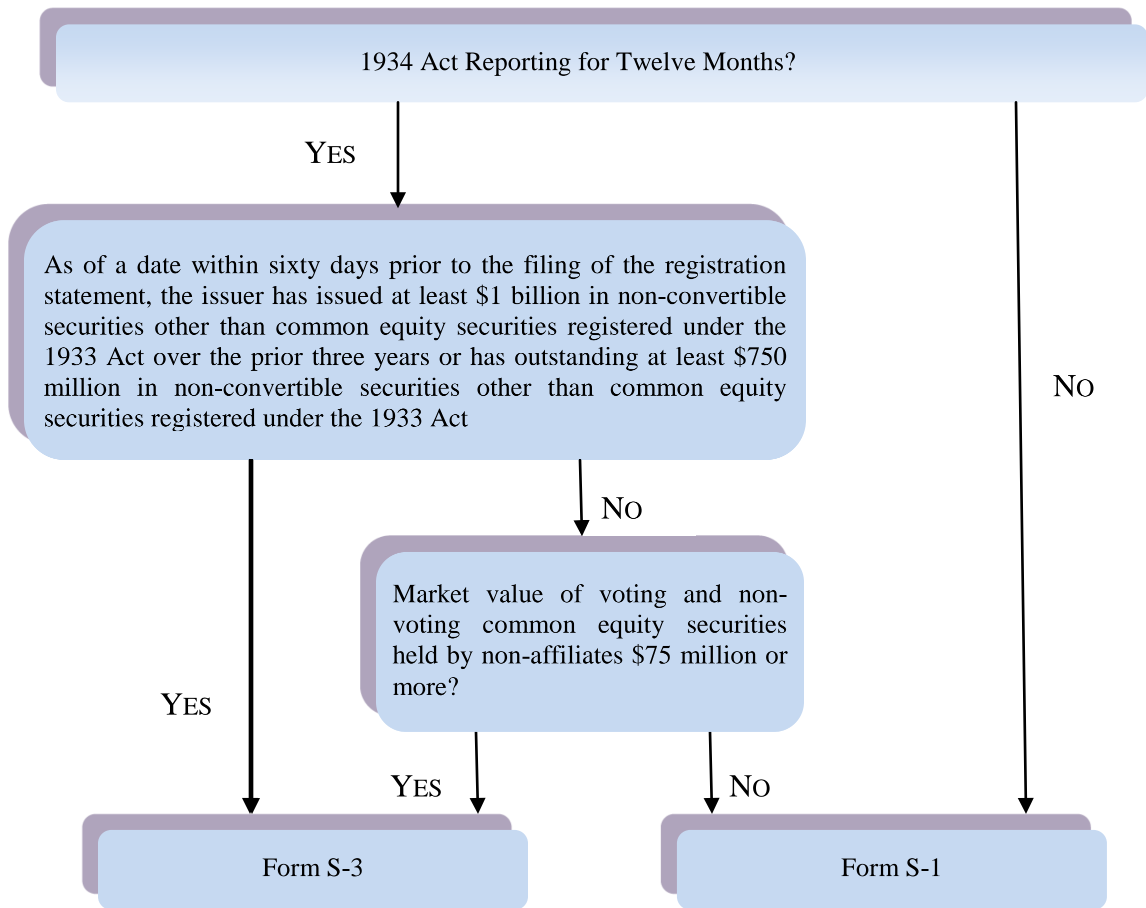

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Eligibility Requirements of Forms S-1 and S-3

Form S-1

Form S-1 is the basic form of registration statement for U.S. issuers that are not eligible to use Form S-3. It is the standard form used by a U.S. issuer for its IPO and any subsequent offerings undertaken before it is eligible to use Form S-3.

Form S-3

Form S-3 is available to U.S. issuers that satisfy the following registrant and transaction requirements:

Registrant Requirements:

(1) the issuer is organized under the laws of the United States and has its principal business operations in the United States or its territories;[111]

(2) the issuer has securities listed on a U.S. securities exchange or is otherwise subject to the reporting requirements of the 1934 Act;

(3) during the twelve calendar months and any portion of a month immediately preceding the filing, the issuer has been subject to the 1934 Act reporting requirements and has made all required 1934 Act filings in a timely manner (except certain reports on Form 8-K);[112]

(4) since the end of the most recent fiscal year for which an annual report on Form 10-K has been filed, neither the issuer nor any of its consolidated or unconsolidated subsidiaries has (a) failed to pay any dividend or sinking fund installment payment on preferred stock or (b) defaulted (i) on any installment or installments on indebtedness for borrowed money or (ii) any long-term lease rentals, which defaults in the aggregate are material to the financial

[111] Pursuant to Instruction I.A.6. to Form S-3, a foreign issuer, other than a foreign government, which satisfies all of the registrant requirements except the requirement that it be organized under the laws of the United States, a state or territory or the District of Columbia and have its principal business operations in the United States or its territories, shall be deemed to have met the registrant requirements under Form S-3 provided that such foreign issuer files the same reports with the SEC under Section 13(a) or 15(d) of the 1934 Act as a domestic registrant.

[112] For investment grade asset-backed securities, to the extent the depositor or any issuer previously established by the depositor or any of its affiliates is or was, at any time during the twelve calendar months immediately preceding the filing of a registration statement, subject to the 1934 Act reporting requirements with respect to asset-backed securities involving the same asset class, such depositor and each such issuer has made all required 1934 Act filings in a timely manner (with the exception of certain filings on Form 8-K).

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position of the issuer and its consolidated and unconsolidated subsidiaries, taken as a whole;

(5) if the issuer is a majority-owned subsidiary, Form S-3 may be used if:

(a) the subsidiary itself meets the requirements of the form;

(b) the parent meets the registrant requirements of the form and the conditions in Transaction Requirements (2) below are met;

(c) (i) the parent meets the registrant and applicable transaction requirements of the form, and (ii) the parent is providing a full and unconditional guarantee of the payment obligations on (iii) the non-convertible securities, other than common equity, of the subsidiary;

(d) (i) the parent meets the registrant and applicable transaction requirements of the form, and (ii) the subsidiary is providing a full and unconditional guarantee of the payment obligations on (iii) the non-convertible securities, other than common equity, of the parent; or

(e) (i) the parent meets the registrant and applicable transaction requirements of the form, (ii) the subsidiary is providing guarantees of the payment obligations on the non-convertible securities, other than common equity, of another majority-owned subsidiary of the parent, and (iii) the parent is also providing a full and unconditional guarantee of such non-convertible securities.

With regard to paragraphs (5)(c), 5(d), and 5(e) above, the guarantor is the issuer of a separate security consisting of the guarantee, which must be concurrently registered, but may be registered on the same registration statement as the non-convertible guaranteed securities.

Transaction Requirements:

(1) securities offered for cash, provided the aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer is $75 million or more;

(2) non-convertible securities, other than common equity, offered for cash provided the issuer:

(a) has issued (as of a date within sixty days prior to the filing of the registration statement) at least $1 billion in non-convertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the 1933 Act, over the prior three years; or

(b) has outstanding (as of a date within sixty days prior to the filing of the registration statement) at least $750 million of non-convertible

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securities, other than common equity, issued in primary offerings for cash, not exchange, registered under the 1933 Act; or

(c) is a wholly-owned subsidiary of a WKSI; or

(d) is a majority-owned operating partnership of a real estate investment trust that qualifies as a WKSI; or

(e) discloses in the registration statement that it has a reasonable belief that it would have been eligible to use Form S-3 as of September 1, 2011, because it is registering a primary offering of non-convertible investment grade securities, discloses the basis for such belief, and files a final prospectus for an offering pursuant to such registration statement on Form S-3 on or before September 2, 2014.

(3) offerings by selling securityholders, including securities acquired by standby underwriters in connection with the call or redemption by the issuer of warrants or a class of convertible securities, if securities of the same class are listed and registered on a national securities exchange;

(4) securities to be offered (i) upon the exercise of outstanding rights granted by the issuer on a pro rata basis to all existing securityholders of the class of securities to which the rights attach, (ii) pursuant to a dividend or interest reinvestment plan or (iii) upon conversion of outstanding convertible securities or the exercise of outstanding warrants or options issued by the issuer or its affiliate;[113]

(5) asset-backed securities offered for cash if at least one nationally recognized statistical rating agency has rated the securities as investment grade;[114] or

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[113] This is available only if the issuer has sent, within the twelve calendar months immediately before the registration statement is filed, certain information to the holders of the convertible securities, warrants, or options.

[114] Investment grade asset-backed securities offerings are eligible to use Form S-3 without any 1934 Act reporting history requirements, thus making Rule 415 shelf registration available for such offerings. See SEC Release No. 33-8518 (Jan. 7, 2005) (http://www.sec.gov/rules/final/33-8518.htm). Form S-3 allows issuers to use short-form registration for all investment grade, asset-backed securities, regardless of the size of the particular issuer's public float, provided the securities meet the Form S-3 standard and any issuer of asset-backed securities involving the same class of asset-backed securities previously established by the depositor or any affiliate made timely 1934 Act filings for the last 12 calendar months. The investment grade rating must exist at the time of sale to the public, not at the time of effectiveness of the registration statement. See SEC Release No. 33-7053 (Apr. 19, 1994). In response to Section 939A of the Dodd-Frank Act, the SEC proposed to remove references to credit ratings as a requirement for shelf eligibility for offerings of asset-backed securities. SEC Release No 33-9117 (Apr. 7, 2010) (continued)

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(6) limited primary offerings of securities for cash by an issuer, other than a shell company, that has at least one class of common equity listed and registered on a national securities exchange. The aggregate market value of securities sold by or on behalf of the issuer pursuant to this section during the period of twelve calendar months immediately prior to, and including, the sale may be no more than one-third of the aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer.

REGISTRATION AND REPORTING UNDER THE 1934 ACT

General

Registration

Before an issuer can list securities on a U.S. securities exchange, the securities must be registered under the 1934 Act. Form 10 can be used to register the securities under the 1934 Act. Alternatively, Form 8-A, an abbreviated 1934 Act registration statement, can be used if the issuer has been filing reports under the 1934 Act or if the listing is being done in connection with an IPO or another public offering registered under the 1933 Act.

Subsequent Reporting

Once an issuer has listed its securities on a U.S. securities exchange, or has registered a public offering of its securities under the 1933 Act, it must then file reports with the SEC pursuant to the 1934 Act to keep the information on file with the SEC (and therefore available to the marketplace) reasonably current. Registration under the 1934 Act is also required for any class of equity securities if, at the end the issuer's fiscal year, the issuer's assets are at least $10 million and the class is held of record by either 500 or more persons who are not accredited investors or 2,000 persons in all. For bank and bank holding companies, the record-holder threshold is 2,000 or more persons. The issuer will have a continuing 1934 Act reporting obligation for as long as its securities are registered under the 1934 Act. If an issuer's 1934 Act reporting obligation is only the result of a 1933 Act registration of securities, reports are required only for the fiscal year during which the securities were registered and any subsequent fiscal year such securities are held of record by 300 or more persons, or, in the case of a bank or bank holding company, 1,200 or more persons, at the beginning of such year. If the registered securities are held by less than 300 or 1,200, as the case may be, record holders on that date, the issuer's 1934 Act reporting obligation is suspended by operation of law.[115]

(http://sec.gov/rules/proposed/2010/33-9117.pdf). The proposal, which is pending, would require sponsors to retain a portion of the asset-backed securities being sold.

[115] See Chapter 7 (*Ongoing Reporting and Other Requirements*) and Chapter 17 (*De-Registering Under the 1934 Act*).

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Although the 1934 Act may permit a company to stop reporting to the SEC, underwriters or investors may contractually require an issuer to file 1934 Act reports voluntarily during the life of the securities to facilitate a secondary market. Any such voluntary reports do not maintain an issuer's eligibility to use Form S-3 because the form allows registration only when the issuer is *required* to report under the 1934 Act. However, continuing voluntary reports under the 1934 Act may facilitate Rule 144A offerings. Another motivation for voluntary 1934 Act reports is that, once a sufficient 1934 Act disclosure systems and controls have been established, updating the disclosure needed for securities offerings is easier. It is important to note, however, that even though an issuer may not be required to register under Section 12(g) of the 1934 Act, once the issuer voluntarily registers under the 1934 Act, such issuer cannot later stop filing reports without termination of registration under the 1934 Act. 1934 Act reporting continues as an obligation until the issuer terminates registration pursuant to Rule 12g-4.

Reports filed with the SEC under the 1934 Act are subject to SEC staff review. While such review had been historically infrequent, Sarbanes-Oxley requires the SEC to review each public company's filings at least once every three years. If the SEC fully reviews a 1933 Act registration statement that incorporates 1934 Act reports by reference (such as Form S-3), the SEC will usually comment on the incorporated reports. Such comments are frequently prospective only. However, the SEC staff may, and sometimes does, insist that 1934 Act reports be amended to respond to its comments as a condition to making the 1933 Act registration statement effective. If an issuer disagrees with the SEC staff's comment, it may respond by explaining its views in correspondence rather than amending the 1934 Act report. If the SEC staff remains unsatisfied and the issuer continues to disagree, the disagreement itself may be required to be disclosed in a subsequent report on Form 10-K if the dispute is material.

1934 Act Reporting Forms for U.S. Issuers

The 1934 Act reporting forms for U.S. issuers are set forth in Forms 10-K, 10-Q, 8-K and Schedule 14A and are part of the SEC's integrated disclosure system.[116]

Filing and Disclosure Requirements of Form 10-K

Form 10-K is divided into a cover page and four parts. "S" filers are required to file annual reports on Form 10-K. An annual report on Form 10-K must be filed (i) in the case of large accelerated filers, within sixty days after the end of the issuer's fiscal year, (ii) in the case of accelerated filers, within seventy-five days after the end of the issuer's fiscal year,

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[116] This discussion does not include other 1934 Act forms or filing requirements that apply as a result of 1934 Act registration outside of the SEC's integrated disclosure system, such as ownership reporting requirements under Sections 13 and 16 which do not apply to issuers, or the tender offer regulation. For a discussion of some of those requirements, see Chapter 7 (*Ongoing Reporting and Other Requirements*) and Chapter 18 (*Acquisitions of U.S. Entities).*

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and (iii) in the case of other issuers, within ninety days after the end of the issuer's fiscal year. The information requirements of Form 10-K are described in Chapter 4 (*Disclosure Requirements*).

Quarterly Reports: Filing and Disclosure Requirements of Form 10-Q

Form 10-Q is divided into a cover page and two parts. A quarterly report on Form 10-Q must be filed after the end of each of the first three fiscal quarters of each fiscal year, but no report need be filed for the fourth quarter of any fiscal year. A quarterly report on Form 10-Q must be filed (i) in the case of large accelerated filers and accelerated filers, within forty days after the end of the fiscal quarter and (ii) in the case of all other issuers, within forty-five days after the end of the fiscal quarter. The information requirements of Form 10-Q are described in Chapter 4 (*Disclosure Requirements*).

Current Reports: Filing and Disclosure Requirements of Form 8-K

Form 8-K is divided into a cover page and nine sections. A report on Form 8-K must be made to the SEC upon the occurrence of any one or more events specified in Sections 1 through 6 and 9 of Form 8-K. Unless otherwise specified, a report is to be filed or furnished within four business days after the occurrence of such an event. The requirements of Form 8-K are described in Chapter 4 (*Disclosure Requirements*).

The information and the exhibits in a Form 8-K, other than those presented in connection with the issuer's earnings release for a completed quarterly or annual fiscal period (unless the issuer specifically states that the information is to be considered "filed" under the 1934 Act) or in connection with the issuer's obligations under Regulation FD to disclose non-public information, is considered "filed" for purposes of Section 18 of the 1934 Act and is subject to the liability provisions of that Section.[117]

Proxy Statements: Filing and Disclosure Requirements

1934 Act Schedule 14A prescribes twenty-four items of disclosure that may be required in a reporting company's proxy statement. Proxy statements may be required to be filed with the SEC in advance of the annual shareholder meeting.[118] A definitive proxy statement must be provided to shareholders in connection with the solicitation of proxies before the annual meeting. While proxy statements are often filed in definitive form and on the same day they are sent to shareholders, under certain circumstances preliminary proxy statements must be submitted to the SEC for prior review. 1934 Act rules do not specify the number of days in advance of the annual shareholder meeting that the final proxy statement

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[117] See Chapter 16 (*Liabilities Under U.S. Securities Laws*).

[118] This discussion focuses on proxy statements in connection with annual shareholder meetings, but proxy statements are required in connection with other proxy solicitations. For a discussion of other types of proxy solicitations, see Chapter 18 (*Acquisitions of U.S. Entities*).

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must be sent to the shareholders, but state corporation laws have notice requirements for annual shareholder meetings, and to the extent the proxy statement serves as notice for such meetings, it must comply with applicable state laws.[119]

Information requirements under Part III of Form 10-K generally are incorporated by reference from the issuer's definitive proxy statement.

[119] The information requirements of Schedule 14A are described in the heading under "Disclosure Requirements of Proxy Statements" in Chapter 4 (*Disclosure Requirements*).

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CHAPTER 4

DISCLOSURE REQUIREMENTS

GENERAL 93
RELATIONSHIP BETWEEN "S" FORMS AND 1934 ACT REPORTS 93
DISCLOSURE REQUIREMENTS OF THE "S" FORMS AND 1934 ACT FILINGS 94
SIGNATURES AND CERTIFICATIONS 127
REDUCED DISCLOSURE REQUIREMENTS FOR EGCS 129
CURRENT REPORTS: DISCLOSURE AND SIGNING REQUIREMENTS OF FORM 8-K 130
DISCLOSURE REQUIREMENTS OF PROXY STATEMENTS 133
DISCLOSURE REGARDING NON-GAAP FINANCIAL MEASURES 157

GENERAL

The SEC has integrated the disclosure requirements for issuers under the 1933 Act and the 1934 Act. This means that one set of disclosure rules applies under both Acts. As a result, most of the information that an issuer is required to include (or incorporate by reference to a 1934 Act report) in a prospectus used to sell securities is based on the information that the issuer is required to disclose in its 1934 Act reports.

The SEC's basic 1933 Act disclosure forms are the "S" forms. Issuers that register their securities offerings under the 1933 Act on an "S" form registration statement file annual reports with the SEC under the 1934 Act on Form 10-K. While "S" forms may be used by foreign private issuers, foreign private issuers are also eligible to register their securities offerings under the 1933 Act on an "F" form registration statement and file annual reports with the SEC under the 1934 Act on Form 20-F or, in the case of certain Canadian issuers, 40-F. As discussed under the heading "Disclosure Requirements for 'F' Form Issuers" in Chapter 4 (*Disclosure Requirements*) of *Accessing the U.S. Capital Markets – Non-U.S. Issuers*, most foreign private issuers choose to register their securities offerings on "F" forms and file annual reports on Form 20-F or, in the case of certain Canadian issuers, Form 40-F, as those registration and reporting regimes are intended to be less burdensome for foreign private issuers.

RELATIONSHIP BETWEEN "S" FORMS AND 1934 ACT REPORTS

Form 10-K is the form to be used by an issuer for annual reports pursuant to Section 13 or 15(d) of the 1934 Act for which no other form is prescribed.[120] The annual report on Form 10-K provides a comprehensive overview of the issuer's business and

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[120] A copy of Form 10-K and related instructions is available at http://www.sec.gov/about/forms/form10-k.pdf.

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financial condition and includes audited financial statements. Form 10-Q is the form to be used by an issuer for quarterly reports pursuant to Section 13 or 15(d) of the 1934 Act.[121] The quarterly report on Form 10-Q provides an overview of the issuer's financial condition for the relevant quarter and includes unaudited financial statements. Form 8-K is the form to be used by an issuer for current reports under Section 13 or 15(d) of the 1934 Act filed pursuant to Rule 13a-11 or Rule 15d-11 under the 1934 Act, for reports of non-public information required to be disclosed by Regulation FD and for certain written communications related to business combination transactions and tender offers.[122] In general, an issuer is required to file current reports on Form 8-K to disclose a number of corporate events that the SEC feels the issuer's stockholders should know about on an expedited basis.

An issuer filing a Form S-1 registration statement needs to include detailed business, financial and other information generally comparable to what would be found in the issuer's Form 10-K annual report, Form 10-Q quarterly reports and Form 8-K current reports for a public reporting company. If the issuer does not yet file periodic reports under the 1934 Act, the issuer will need to create substantially similar levels of disclosure for inclusion in the registration statement.

An issuer using a Form S-3 registration statement must incorporate by reference into the prospectus the issuer's latest annual report on Form 10-K filed pursuant to the 1934 Act that contains financial statements for the issuer's latest fiscal year for which a Form 10-K was required to have been filed and all other reports on Forms 10-Q and 8-K filed pursuant to Section 13(a) or 15(d) of the 1934 Act since the end of the fiscal year covered by such Form 10-K. Furthermore, a Form S-3 prospectus automatically incorporates by reference all reports including, among others, annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K subsequently filed by the issuer under the 1934 Act, and is generally kept current by information contained in such reports.

DISCLOSURE REQUIREMENTS OF THE "S" FORMS AND 1934 ACT FILINGS

The following table summarizes the information that the SEC requires be included in registration statements on Form S-1 and S-3, annual reports on Form 10-K and quarterly reports on Form 10-Q. The table is divided into three sections:

- The first section covers offering-related information that is relevant to a registration statement on Form S-1 or S-3.
- The second section describes issuer-related information that is relevant to registration statements on Form S-1 and S-3 and reports on Form 10-K and 10-Q.

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[121] A copy of Form 10-Q and related instructions is available at http://www.sec.gov/about/forms/form10-q.pdf.

[122] A copy of Form 8-K and related instructions is available at http://www.sec.gov/about/forms/form8-k.pdf.

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- The third section discusses required exhibits and schedules and, in the case of registration statements, information that is included in Part II of the registration statement but is not contained in the prospectus delivered to investors.

The following table does not address the disclosure requirements of Current Reports on Form 8-K or proxy statements, which are described below under the headings "Current Reports: Disclosure and Signing Requirements of Form 8-K" and "Disclosure Requirements of Proxy Statements," respectively.

In addition, as described further in "Section V: Selected Issuers," the SEC has adopted certain "industry guides" that require additional specialized disclosure[123] with respect to the following types of companies:

- Oil and Gas Operating Companies (Guide 2);
- Bank Holding Companies (Guide 3);
- Oil and Gas Programs (Guide 4);
- Real Estate Limited Partnerships (Guide 5);
- Property-Casualty Insurance Companies (Guide 6); and
- Mining Companies (Guide 7).

There also are specialized forms to be used in place of Form S-1, such as Form S-11 for real estate investment trusts, Form N-1A for mutual funds and other open-end management investment companies and Form N-8B-2 for certain unit investment trusts.

It is important to remember that Forms 10-K, 10-Q and 8-K are not blank forms for filling in required information. These forms are meant to be a guide only for the preparation of the relevant report. Form 10-K expressly notes the requirements of Rule 12b-20 under the 1934 Act that "[i]n addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."

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[123] The industry guides are available on the SEC's web site at http://www.sec.gov/about/forms/industryguides.pdf.

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The following table is followed by a summary of some of the information that must be included in a registration statement or report pursuant to applicable SEC rules. In many cases these rules are complex and highly detailed and, accordingly, no attempt has been made to summarize these rules in their entirety. Rather, this summary highlights some of the significant features of these rules and, in certain cases, related market practice.

	Offering-Related Information	**S-1**	**S-3**	**10-K**	**10-Q**
1.	Description of securities to be registered (S-K Item 202)	X	X		
2.	Forepart of the registration statement and outside front cover of prospectus (S-K Item 501)	X	X		
3.	Inside front cover and outside back cover pages of prospectus (S-K Item 502)	X	X		
4.	Summary information and ratios of earnings to fixed charges (S-K Item 503)	X	X		
5.	Use of proceeds (S-K Item 504)	X	X		
6.	Determination of offering price (S-K Item 505)	X	X		
7.	Dilution (S-K Item 506)	X	X		
8.	Selling securityholders (S-K Item 507)	X	X		
9.	Plan of distribution (S-K Item 508)	X	X		
10.	Interests of named experts and counsel (S-K Item 509)	X	X		
11	Disclosure of SEC position on indemnification for 1933 Act liabilities (S-K Item 510)	X	X		

	Issuer-Related Information	**S-1**	**S-3**	**10-K**	**10-Q**
12.	Description of business (S-K Item 101)	X		X	
13.	Description of property (S-K Item 102)	X		X	
14.	Legal proceedings (S-K Item 103; in addition, Item 3(b) of Form 10-K requires similar information for any legal proceeding terminated during the fourth quarter of the fiscal year and Item 1 of Form 10-Q requires similar information for any legal proceeding terminated during the period covered by the report)	X		X	X
15.	Mine safety, Resource Extraction and Conflict Minerals Disclosure			X	X
16.	Disclosure of Sanctions Violations			X	X
17.	Market for the issuer's common equity and related stockholder matters (S-K Item 201)	X		X	
18.	Selected financial data (S-K Item 301)	X		X	
19.	Supplementary financial information (S-K Item 302)	X		X	

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	Issuer-Related Information	S-1	S-3	10-K	10-Q
20.	Management's discussion and analysis of financial condition and results of operations (S-K Item 303)	X		X	X
21.	Changes in and disagreements with accountants (S-K Item 304 for Form S-1; S-K Item 304(b) for Form 10-K)	X		X	
22.	Quantitative and qualitative disclosures about market risk (S-K Item 305)	X		X	X
23.	Disclosure and internal controls and procedures (S-K Items 307 and 308 for Form 10-K; S-K Items 307 and 308(c) for Form 10-Q)			X	X
24.	Directors and executive officers (S-K Item 401)	X			
25.	Directors and executive officers, compliance with Section 16(a) of the 1934 Act, code of ethics and corporate governance (S-K Items 401, 405, 406 and 407(c)(3), (d)(4) and (d)(5))			X	
26.	Executive compensation (S-K Item 402) and corporate governance (S-K Item 407(e)(4) plus, for Form 10-K, S-K Item 407(e)(5))	X		X	
27.	Security ownership of certain beneficial owners and management (S-K Item 403 plus, for Form 10-K, S-K Item 201(d))	X		X	
28.	Related person transactions (S-K Item 404) and director independence (S-K 407(a))	X		X	
29.	Material changes in procedures for nominating directors (S-K 407(c)(3)) (in the case of an annual report on Form 10-K, this information is covered in item 23 above)			X	X
30.	Risk factors (S-K Item 503(c) or, for Form 10-Q, Item 1A of Form 10-Q)	X	X	X	X
31.	Recent sales of unregistered securities; use of proceeds from sale of registered securities (S-K Item 701)			X	X
32.	Repurchases of equity securities (S-K Item 703)			X	X
33.	Material changes in the company's business since the end of the latest fiscal year covered by audited financials that have not been described in a document incorporated by reference (Item 11A of Form S-1 and Item 11 of Form S-3)	X	X		
34.	Incorporation by reference (Item 12 of Form S-1 and Form S-3)	X	X		
35.	Unresolved SEC staff comments (Item 1B of Form 10-K)			X	
36.	Defaults upon senior securities (Item 3 of Form 10-Q)				X
37.	Other information required to be disclosed in a report on Form 8-K but not reported (Item 9B of Form 10-K and Item 5(a) of Form 10-Q)			X	X
38.	Principal accounting fees and services (Item 14 of Form 10-K)			X	
39.	Financial statements (Regulation S-X)	X		X*	X*

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	Exhibits, Schedules, and Information Not Required in Prospectus	**S-1**	**S-3**	**10-K**	**10-Q**
40.	Other expenses of issuance and distribution (S-K Item 511)	X	X		
41.	Undertakings (S-K Item 512)	X	X		
42.	Exhibits (S-K Item 601)	X	X	X**	X**
43.	Recent sales of unregistered securities (S-K Item 701)	X			
44.	Indemnification of directors and officers (S-K Item 702)	X	X		
45.	Financial statement schedules (Regulation S-X)	X		X	
46.	Supplemental information required for issuers that have not registered securities pursuant to Section 12 of the 1934 Act			X	

Note: "Smaller reporting companies" (defined, in general, as companies with a public float of less than $75 million) are entitled to comply with a less burdensome form of the disclosure required by Items 101, 201, 301, 302, 303, 305, 402, 404, 407, 503, 504 and 601 of Regulation S-K. EGCs (defined, in general, as companies with total annual gross revenues of less than $1 billion during the most recent fiscal year) may elect to comply with a less burdensome form of the disclosure required by Items 301 and 402 of Regulation S-K for up to five years unless certain disqualifying events occur.

* Sometimes these financial statements are included as an exhibit to the Form 10-K or Form 10-Q.

** Including, but not limited to, the certifications required pursuant to Rules 13a-14(a) and 13a-14(b) under the 1934 Act.

1. Description of securities to be registered

In the case of a registration statement on Form S-1 or S-3, a summary of the terms of the securities being offered is required. In the case of common stock, the summary tends to be relatively short and typically covers, among other things, anti-takeover provisions in the issuer's organizational documents and under applicable law. Descriptions of fixed income securities can be quite lengthy and may repeat, virtually word for word, applicable financial covenants and definitions and events of default. However, these descriptions typically follow well-established formats.

2. Forepart of the registration statement and outside front cover page of prospectus

The name of the issuer, the title and amount of securities offered, the offering price, the name of any securities exchange on which the securities are listed, whether the securities are being sold by the issuer or by selling securityholders or both, the nature of the underwriting arrangements (*e.g.*, firm commitment or best efforts) and certain legends and other ministerial information must appear on the front cover of the prospectus. Issuers sometimes also include a brief statement about their business on the front cover.

3. Inside front and outside back cover pages of prospectus

In the case of Form S-1 only, a table of contents must be included on the inside front or outside back cover page. For IPOs, a legend regarding post-offering delivery of the prospectus by dealers is required.

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4. Summary information and ratios of earnings to fixed charges

Summary Information. A summary of the information in the prospectus is not mandatory unless "the length or complexity of the prospectus makes a summary useful." However, many issuers and underwriters believe that, particularly for IPOs and other offerings that are actively marketed, the description of the issuer appearing in the prospectus summary is the single most critical part of the prospectus. While there is no requirement as to what a prospectus summary must contain, most summaries contain some or all of the following elements:

- **Summary description of the business of the issuer** - This can range in length from a single paragraph (for well-established issuers that are widely followed by analysts or that regularly offer securities in the capital markets) to upwards of five or six pages (for IPOs and other marketed offerings). For IPOs and some other offerings, the summary may include sections describing the issuer's competitive strengths and strategies. Often there also is a brief description of the relevant industry or market, company history and significant developments, such as important product introduction or development efforts or material acquisitions.

- **Summary of the offering** - Usually a page or two in length in the case of a common stock offering and often two or three pages in the case of a preferred stock or debt offering, this section describes the number and type of securities being offered, indicates whether the securities are being offered by the issuer or selling securityholders, summarizes the use of proceeds and, if applicable, mentions any stock exchange where the securities are listed. This section may also include, in the case of common stock offerings, information as to the number of outstanding shares, options and other common stock equivalents and the number of shares authorized for future issuance under equity incentive plans and, in the case of debt and other fixed income securities, the principal financial terms (such as interest rate, maturity date and redemption provisions) and a brief statement regarding covenants and other terms of the securities.

- **Summary financial data** - Typically a page or two in length, this section presents, in tabular form, condensed historical income statement data, usually for the last three or five years (or since inception, if shorter) plus any interim or "stub" period and the comparable prior year period. Condensed balance sheet data is also typically included, either as of the end of each of the foregoing periods or only as of the end of the most recent fiscal year and stub period, with most recent information usually presented both on an historical basis and as adjusted to give effect to the offering or other offerings where preferred stock will automatically convert to common stock upon consummation of the offering. In financings involving significant acquisitions, pro forma information reflecting the conversion or the acquisition is often included in the summary and the as adjusted balance sheet data. Summary financial data is often omitted by established issuers.

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Ratio of Earnings to Fixed Charges. This item is only required if preferred stock, debt securities or other fixed-income securities are being registered. The ratio is calculated in accordance with SEC requirements and must be provided for the last five fiscal years (or since inception, if shorter) plus any stub period. A pro forma ratio for the most recent fiscal year and stub period is required if (i) the offering proceeds are to be used to retire indebtedness or other securities and (ii) after giving pro forma effect to the issuance of the new securities and the use of proceeds, the pro forma ratios would differ from the historical ratios by 10% or more. If the ratio indicates less than a one-to-one coverage the ratio itself generally is not given and, instead, the dollar amount of the deficiency must be disclosed.

5. Use of proceeds

Often limited to one or two paragraphs, this item requires a description of how the issuer intends to use the net proceeds from the offering. The description may be quite general, simply indicating that proceeds will be used for general corporate purposes, or quite specific, indicating each purpose for which the proceeds will be used and the amount to be applied for each such purpose. Although not required, it is typical to include the estimated amount of net proceeds, after deducting underwriting discounts and commissions and offering expenses payable by the issuer. Certain limited additional disclosure will be required where part of the proceeds are to be used to discharge debt and may be required where, for example, additional financing will be necessary to accomplish the purpose for which the proceeds will be used or where the proceeds are used to repay indebtedness. SEC comments on this section often ask whether more detailed disclosure of the contemplated use of proceeds can be provided.

6. Determination of offering price

If the offering relates to common stock that is not listed on a securities exchange or traded in an established public market (*i.e.*, an IPO), the prospectus must briefly describe the factors considered in determining the offering price. In practice, this discussion (which usually appears in the "Underwriting" section of the prospectus) typically contains boilerplate to the effect that the offering price was determined by negotiations among the issuer, any selling securityholders and the underwriters and lists some of the factors considered in making that determination.

7. Dilution

This disclosure is only required if common equity securities are being registered and either:

- (a) the issuer is not subject to the reporting requirements of the 1934 Act (*i.e.*, an IPO) and (b) there is a "substantial disparity" between the public offering price and the price at which officers, directors or other affiliates purchased the common stock during the past five years; or

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- the issuer has had losses in each of its last three fiscal years and there will be a material dilution of purchasers' equity interest.

In those cases, the prospectus must disclose:

- the issuer's net tangible book value per share before (which in some cases is stated on a pro forma basis) and after the offering;
- the amount of the increase in such net tangible book value per share attributable to cash payments made by purchasers of the shares being offered; and
- the amount of the immediate dilution from the public offering price which will be absorbed by new investors.

In practice, the disclosure in response to this item typically provides certain information in addition to that required by the rule. This additional information typically consists of a table showing the respective amounts invested by existing stockholders and the new investors and the respective percentages of the issuer's stock to be owned by them giving effect to the offering.

8. Selling securityholders

The following information must be included if stockholders or other securityholders are selling shares or other securities in the offering:

- the name of each selling securityholder and any position, office or other material relationship with the issuer or any of its affiliates during the past three years; and
- the amount of securities owned by the selling securityholder prior to the offering, the amount to be sold and the amount and the percentage (if one percent or more) to be owned after the offering.

This information is typically presented in tabular form and, in the case of IPOs and other common stock offerings on Form S-1, is typically combined with information on securities owned by officers, directors and principal stockholders.

9. Plan of distribution

This item, which is typically headed "Underwriting" in the case of an underwritten offering, summarizes the manner in which the securities are to be offered and sold to the public. In the case of offerings to be sold through underwriters or agents, this section will name the underwriters and agents, indicate whether the offering is being made on an underwritten or "best efforts" basis, summarize certain other terms of the distribution, including compensation to be paid to the underwriters or agents, describe any stabilization or market-making transactions that the underwriters or agents may undertake, and describe any material relationships between the underwriters and the issuer. In the case of offerings to be

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distributed outside of the United States, this section may include a summary of the selling restrictions imposed by applicable foreign law. In the case of IPOs, the disclosure in response to this item also usually includes a brief (and relatively standard) description of the manner in which the underwriters, any selling stockholders and the underwriters established the public offering price and a statement regarding sales to discretionary accounts.

If the registration statement covers sales to be made by selling securityholders from time to time (rather than in an underwritten offering), the plan of distribution section typically summarizes a broad range of transactions in which the selling securityholders may dispose of their securities. This disclosure should be updated from time to time if major changes are made, such as new arrangements for a firm commitment underwriting.

10. Interests of named experts and counsel

The prospectus contains descriptions of the parties that expertise information contained or incorporated by reference in the prospectus (*e.g.*, accountants and engineers) and lawyers or law firms that opine on the validity of the securities being registered or other legal matters related to the offering. If any accountant or other "expert" named in the registration statement, or any lawyer or law firm named in the prospectus as having given an opinion on the validity of the securities being registered or other legal matters in connection with the registration or offering of the securities, was employed for such purpose on a contingent basis or had, or is to receive in connection with the offering, a "substantial interest" in the issuer or any of its parents or subsidiaries or was connected with the issuer as a promoter, principal underwriter, director, officer or employee, a brief statement describing that relationship must be included. An interest of an expert (other than an accountant) or counsel is deemed substantial if it equals or exceeds $50,000.

11. Disclosure of SEC position on indemnification

An undertaking regarding the SEC's position on indemnification for 1933 Act liabilities must be included in Part II of a registration statement on Form S-1 or S-3 if the issuer plans to seek acceleration of the registration statement's effective date or if the registration statement is an automatic shelf registration statement that will become effective automatically. See Item 41 below. In rare cases where acceleration is not requested or automatic, Item 510 of Regulation S-K requires that this information be included in the prospectus.

12. Description of business

The description of the issuer's business is one of the most important and, typically, one of the longest sections in a prospectus. Although there are detailed SEC rules about certain elements that must be included in this section, the information actually included tends to substantially exceed the minimum SEC requirements. For new issuers, the best source of guidance regarding the information that should be included in the business section often may be the disclosure documents of comparable companies in the same industry. However, as issuers mature they may eliminate some of the marketing-oriented discussion that more

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typically appears in the business section for an IPO. Some of the major elements required by the SEC's rules are summarized below.

- Financial information for each industry "segment," as defined by generally accepted accounting principles. This information is typically included in the notes to the financial statements, although the discussion in the business section and in MD&A is often divided to cover each industry segment separately.

- Narrative description of the business, focused upon the issuer's dominant segment or each segment for which financial information is presented. This includes information regarding principal products and services; sources and availability of raw materials; intellectual property and franchises; seasonality of the business; dependence upon a limited number of customers or suppliers; if applicable, the dollar amount of backlog; a description of any material contracts that are subject to renegotiation or termination at the election of a governmental body; competition; amounts spent on research and development; environmental matters; and information regarding employees and labor unions.

- Financial information for geographic segments. This information is typically included in the footnotes to the financial statements, although information about risks of foreign operations is typically included in the business section, MD&A and, if applicable, the risk factors section.

- The business description (especially in the case of IPOs) often also includes a description of the industry or markets in which the issuer competes.

13. Description of property

This item requires a brief statement of the location and general character of the issuer's principal plants, mines and other material properties, both owned and leased, disclosure of major encumbrances and identification of the reportable segments utilizing those properties. The scope of this disclosure varies widely among industries. For small or early-stage companies, this section may state the location of owned and leased properties and the square footage. For retail businesses, this may include a tabular presentation of stores, indicating which locations are owned or leased and square footage. For industrial companies, this may include the location of major manufacturing and office facilities. This section tends to be relatively brief except in the case of real estate, mining or oil and gas companies or other companies in which real property is especially important.

14. Legal proceedings

This item requires a description of material legal proceedings to which the issuer or any of its subsidiaries or properties is subject, other than ordinary routine litigation incidental to the business. It also requires similar information as to any such proceedings known to be contemplated by government authorities. In practice, most companies will describe all material litigation and other governmental proceedings, whether or not considered ordinary

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or routine. Likewise, although the SEC rules indicate that no information is required with respect to any proceeding that involves primarily a claim for damages that, together with other pending or contemplated proceedings presenting in large degree the same legal and factual issues, do not in the aggregate exceed 10% of the company's consolidated current assets, an issuer may disclose a claim that is below this threshold if they consider it material. In addition, any material bankruptcy proceedings regarding the issuer or any of its significant subsidiaries or an environmental action brought by a governmental authority that may result in damages of greater than $100,000 must be disclosed.

15. Mine safety resource extraction and conflict minerals disclosure

If the issuer or one of its subsidiaries is the operator of a coal or other mine that is subject to the Federal Mine Safety and Health Act of 1977, the issuer must include a report regarding mine safety violations and other regulatory matters as an exhibit to its reports on Form 10-K and 10-Q and include a statement in the body of the report indicating that the report has been filed as required.

On August 22, 2012, the SEC adopted final rules it was directed to adopt under Section 1502 of the Dodd-Frank Act, regarding disclosure of any use of "conflict minerals" originating in the Democratic Republic of Congo or one of its eight bordering nations, and Section 1504 of the Dodd-Frank Act, regarding disclosure of certain payments made to the United States or a foreign government by issuers that are engaged in the commercial development of oil, natural gas or minerals.

As directed by Section 1504 of the Dodd-Frank Act, the SEC recently adopted final rules requiring certain disclosures by issuers that engage in the commercial development of oil, natural gas or minerals, including foreign issuers and smaller reporting companies ("resource extraction issuers"). A resource extraction issuer must disclose in its annual report the information relating to any "not *de minimis*" payment made by such issuer, or by a subsidiary or entity under control of such issuer, to the U.S. federal government or a foreign government for the purposes of the commercial development of oil, natural gas or minerals. Under the new rules, "not *de minimis*" includes any payment (whether a single payment or a series of related payments) that equals or exceeds $100,000 during the most recent fiscal year and the "commercial development of oil, natural gas or minerals" includes exploration, extraction, processing and export, or the acquisition of a license for any such activity.

The required disclosure includes the type and total amount of payments made for each project related to resource extraction, the type and total amount of payments made to each government, the currency used to make the payments, the financial period in which the payments were made, the business segment making the payments, the government that received the payment (including the country in which such government is located) and the project to which the payments relate. The rules intentionally do not define "project" in order to allow issuers flexibility in applying the term. "Payments" related to commercial development activities that must be disclosed include taxes, royalties, fees (including license fees), production entitlements, bonuses, dividends and payments for infrastructure improvements.

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An issuer is required to disclose the relevant information annually by filing new Form SD (for "specialized disclosure"), no later than 150 days after the end of its fiscal year. The information must be included in an exhibit and electronically tagged using XBRL interactive data format. The new rules must be complied with for fiscal years ending after September 30, 2013. However, for the first report, most issuers may provide a partial report disclosing only those payments made after September 30, 2013.

As directed by Section 1502 of the Dodd-Frank Act, on August 22, 2012, the SEC adopted final rules regarding disclosure of the use of conflict minerals, which include cassiterite (used to make tin), columbite-tantalite (used to make tantalum), gold, wolframite (used to make tungsten), certain derivatives, and any other minerals specified by the U.S. Secretary of State originating in the Democratic Republic of Congo or one of its nine bordering nations ("Covered Countries"). Under the new rules, issuers must determine whether any such conflict minerals are "necessary to the functionality or production" of a product manufactured or contracted to be manufactured by such issuer. The rules do not define the term "contracting to manufacture," but according to SEC commentary it would include any case where the issuer exerts actual influence over the product's manufacturing (which would not include cases where the issuer merely affixes its brand name to a generic product manufactured by a third party, where the issuer services or repairs products manufactured by a third party, or where the issuer negotiates terms with a manufacturer that do not relate to the manufacturing of the product).

If an issuer determines that conflict minerals are not necessary to the functionality or production of a product it manufactures or has contracted to manufacture, it is not required to submit a conflict minerals report to the SEC or take any other action.

However, if an issuer concludes that conflict minerals are necessary to the functionality or production of a product it manufactures or has contracted to manufacture, the new rules require it to conduct a good faith reasonable "country of origin inquiry" to determine whether the conflict minerals originated in the Covered Countries.

If, based on such inquiry, an issuer concludes that its conflict minerals did not originate in the Covered Countries, or if the issuer has no reason to believe that the minerals may have originated in the Covered Countries, the issuer must:

- disclose its conclusion and the inquiry process it used to arrive at such conclusion on Form SD filed with the SEC; and

- make such disclosure available on its website.

Alternatively, if, based on a reasonable country of origin inquiry, an issuer concludes that its conflict minerals did originate in the Covered Countries, or if the issuer has reason to be believe that the conflict minerals may have originated in the Covered Countries, the issuer must:

- disclose this conclusion on Form SD;

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- submit a conflict minerals report to the SEC and furnish it as an exhibit to Form SD; and
- post the conflict minerals report on its website.

Required disclosures must be made on new Form SD instead of included in annual reports on Form 10-K or 20-F. Form SD will be required for calendar years, without regard to an issuer's fiscal year. The first such report, covering 2013, will be required on May 31, 2014. The SEC's adopting release includes the chart below which illustrates the application of the new rules. The new rules will be applicable to many, if not most, public companies engaged in manufacturing.

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Conflict Minerals Application Chart

START
Does the issuer file reports with the SEC under Section 13(a) or 15(d) of the Exchange Act?

YES → Does the issuer manufacture or contract to manufacture products?

YES → Are conflict minerals necessary to the functionality or production of the product manufactured or contracted to manufacture?

NO

Rule does not apply. END

NO

NO

YES

Were the conflict minerals outside the supply chain prior to January 31, 2013?

YES

NO, if potentially scrap or recycled

NO, if newly mined

Based on a reasonable country of origin inquiry (RCOI), does the issuer know or have reason to believe that the conflict minerals may have originated in the DRC or an adjoining country (the covered countries?

YES

NO

Based on the RCOI, does the issuer know or reasonably believe that the conflict minerals come from scrap or recycled?

NO

YES

File a Form SD that discloses the issuer's determination and briefly describes the RCOI and the results of the inquiry.
END

Exercise due diligence on the source and chain of custody of its conflict minerals following a nationally or internationally recognized due diligence framework, if such framework is available for a specific conflict mineral.

In exercising this due diligence does the issuer determine the conflict minerals are not from the covered countries or are from scrap or recycled?

YES

File a Form SD that discloses the issuer's determination and briefly describes the RCOI and due diligence measures taken and the results of the inquiry.
END

NO

File a Form SD with a Conflict Minerals Report as an exhibit, which includes a description of the measures the issuer has taken to exercise due diligence.

In exercising this due diligence was the issuer able to determine whether the conflict minerals financed or benefitted armed groups?

NO

Is it less than two years after effectiveness of the rule (four years for Smaller Reporting Companies)?

YES

The Conflict Minerals Report must also include a description of products that are "DRC Conflict Undeterminable" and the steps taken or that will be taken, if any, since the end of the period covered in the last Conflict Minerals Report to mitigate the risk that the necessary conflict minerals benefit armed groups, including any steps to improve due diligence. No audit is required.
END

NO

YES

The Conflict Mineral Report must also include an independent private sector audit report, which expresses an opinion or conclusion as to whether the design of the issuer's due diligence measures is in conformity with the criteria set forth in the due diligence framework and whether the description of the issuer's due diligence measures is consistent with the process undertaken by the issuer. Also, include a description of the products that have not been found to be DRC Conflict Free, the facilities used to process the necessary conflict minerals in those products, the country of origin of the minerals and the efforts to determine the mine or location of origin of those minerals with the greatest possible specificity.
END

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16. Iran Threat Reduction and Syria Human Rights Act of 2012

The Iran Threat Reduction and Syria Human Rights Act of 2012 added Section 13(r) to the 1934 Act. Section 13(r) applies to annual and quarterly reports due after February 6, 2013, and requires that the issuer disclose if, during the reporting period, the issuer, or any of its affiliates (which includes any entity that directly or indirectly controls, is controlled by, or is under common control with the issuer), knowingly engaged in a wide range of proscribed activities, including:

- violations of the Iran Sanctions Acts of 1996 or the Comprehensive Iran Sanctions, Accountability and Divestment Act of 2010;
- transactions with persons or entities listed on the U.S. Department of the Treasury's Office of Foreign Assets Control's Specially Designated Nationals and Blocked Persons; and
- transactions with the government of Iran or any entity that is owned or controlled, directly or indirectly, by the government of Iran.

If the issuer determines that there was no reportable activity, no disclosure or negative statement is required in the applicable report. However, if there was a reportable activity, the applicable report must include a detailed description of:

- the nature and extent of the activity;
- the gross revenues and net profits attributable to the activity; and
- whether the issuer or affiliate intends to continue the activity.

In addition, the issuer must send a separate form to the SEC, which will be publicly posted on EDGAR as an "IRANNOTICE" and forwarded to the President of the United States for investigation.

Section 13(r) does not include a materiality threshold or *de minimis* exception, and thus even minor violations must be identified and reported. Further, the list of proscribed activities is extensive, complex, and often ambiguous. For example, the definition of the Iranian government includes any entity under its indirect control. Given the Iranian government's broad involvement in Iran's economy, interpreting this control standard and gathering the necessary information from third parties may be challenging. Further, since some issuers may not have enough control over certain affiliates to require their full cooperation (such as a controlling shareholder or joint venture) it may be challenging for these issuers to identify and provide sufficiently detailed disclosure of any violations.

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17. Market for the issuer's common equity and related stockholder matters

The following information must be included if common stock is being registered on Form S-1 and in annual reports on Form 10-K:

- Name of the principal U.S. market on which the common stock is traded or, if none, a statement to that effect.

- The high and low sales prices on the principal U.S. market for each quarter in the two most recent fiscal years and, except in the case of a Form 10-K, any subsequent interim period for which financial statements are presented (in practice, a prospectus will usually provide this information through a date shortly before the date of the prospectus).

- If common stock for which there is no established U.S. public trading market is being registered on Form S-1, the amount of common stock that is subject to outstanding options or warrants or issuable on exercise of convertible securities, that could be sold pursuant to Rule 144, that is entitled to registration rights, or that the issuer is proposing to publicly offer.

- The approximate number of holders of common stock as of the latest practical date.

- The frequency and amount of any cash dividends during the two most recent fiscal years and any subsequent interim period for which financial statements are presented (in practice, a prospectus will usually provide this information through a date shortly before the date of the prospectus), as well as any contractual or other restrictions on dividends. Issuers that do not pay cash dividends and that do not have any intention of paying cash dividends in the future typically include a statement to that effect.

In the case of a Form 10-K, the issuer must include, in tabular form, the following information for equity securities issuable under compensation plans:

- number of securities issuable upon exercise of outstanding options, warrants and rights,

- weighted-average exercise price per share of outstanding options, warrants and rights, and

- number of securities available for future issuance under equity compensation plans.

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18. Selected financial data

This item requires tabular presentation of selected income statement and balance sheet items for each of the last five fiscal years. In addition, while data for any interim period since the end of the last fiscal year is not required, it is typically included in registration statements. If interim period financial statements are included, or are required to be included by Article 3 of Regulation S-X, issuers should consider whether the selected financial data should be updated for such interim period to reflect a material change in the trends indicated. In cases where such updating is necessary, issuers shall provide the interim period financial information on a comparative basis unless not necessary to an understanding of such updating information. While the SEC rules specify a limited number of items that should be included in this table, some issuers include all or substantially all of the line items from the income statement (although it is relatively rare to include all balance sheet line items). Some issuers may include other financial and operating metrics in this table, such as cash flow data, unit volume of certain product sales, average sales per store, number of customers or other industry-specific data. SEC rules also require a description or cross reference to a discussion of factors, such as accounting changes and business combinations and dispositions of businesses, that materially affect the comparability of the information between periods.

As discussed below under "Reduced Disclosure Requirements for EGCs," companies that qualify as EGCs are only required to present selected financial data in any registration statement, annual report or periodic report for periods preceding the earliest audited period in the registration statement used for its initial public offering.

19. Supplementary financial information

This item applies to issuers that have become subject to the reporting requirements of the 1934 Act either because they have registered a security on a national securities exchange pursuant to Section 12(b) of the 1934 Act or because their securities are owned by more than 500 holders as contemplated by Section 12(g) of the 1934 Act. As most issuers become subject to the reporting requirements of the 1934 Act pursuant to Section 15(d) (which applies if a registration statement filed by the issuer has become effective), this item is rarely applicable. If this section is applicable to an issuer, this supplementary financial information often appears as an exhibit to the registration statement or Form 10-K, as the case may be. See Item 46 below.

20. Management's discussion and analysis of financial condition and results of operations

This item, commonly referred to as "MD&A," is one of the most important (and typically one of the longest) sections in a registration statement or report. The primary purpose of this item is to discuss changes in the issuer's results of operations over the relevant period or periods, as well as the issuer's liquidity and the availability of funding to meet cash needs. This section has expanded substantially in recent years and often receives detailed comments from the SEC. The purpose is not merely to analyze historical results but

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to help the reader see the issuer "through the eyes of management." Major components of the MD&A typically include the following.

- **Critical Accounting Policies and Practices** – The SEC expects issuers to include a discussion of all accounting policies that management believes are most critical to the preparation of the issuer's financial statements. The SEC regards critical accounting policies as those that are both important to the issuer's financial condition and results and that require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.[124] This disclosure often also covers pending or proposed changes in accounting standards that may affect the issuer's results or financial condition going forward.

- **Results of Operations** – A discussion of changes in various income statement line items for the periods presented, together with an explanation of the material reasons for those changes. For example, a Form 10-K prepared for the fiscal year ended December 31, 2012 includes audited income statements for fiscal years 2010, 2011 and 2012. Accordingly, MD&A will typically include a section comparing operating results for 2012 to 2011, and a separate section comparing 2011 to 2010. Likewise, a Form 10-Q for the second fiscal quarter will typically include a discussion of the first six months of the current year compared to the first six months of the prior year and, in some cases, a discussion of operating results for the second quarter of the current fiscal year compared to the second quarter of the prior fiscal year. A registration statement on Form S-1 will typically include a similar year-to-year discussion, although the discussion of any interim period will typically cover only the most recent three-, six-, or nine-month period compared to the same interim period in the prior year.

  The SEC has emphasized that issuers should disclose in MD&A any "known trends or uncertainties" that have had or, more importantly, are reasonably expected to have a material favorable or unfavorable impact on future results of operations or financial conditions. The SEC has indicated that management should use the following two-prong test in determining whether a trend or uncertainty should be disclosed in MD&A[125]:

  - Is the known trend, demand, commitment event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.

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[124] See SEC Release No. 33-8183 (Jan. 28, 2003) (http://www.sec.gov/rules/final/33-8183.htm).

[125] See also Appendix D (Summary of SEC Releases on MD&A).

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- If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the issuer's financial condition or results of operations is not reasonably likely to occur.

  Note that "reasonably likely" is a lower threshold than "more likely than not" but a higher threshold than "remote". The concept of "reasonably likely" is used in the context of disclosure for MD&A purposes and is not intended to mirror the tests in ASC 450 (formerly SFAS 5) established to determine when financial statement accrual is necessary or when disclosure in the footnotes to the financial statements is required. In some cases, a failure to adequately foreshadow the effect of known material trends or uncertainties has resulted in SEC enforcement action.

- **Liquidity and Capital Resources** – The purpose of this section is to identify known trends or uncertainties likely to have a material effect on the issuer's liquidity, as well as material commitments for capital expenditures. In practice, this section will often include a brief discussion of the issuer's cash flows as reflected in its financial statements, followed by a description of available credit facilities and any material financings undertaken by the issuer in the relevant periods, as well as information regarding anticipated capital and other significant expenditures. Early stage companies often include a statement indicating how long they expect their available cash and other sources of financing will sustain their operations. Recent interpretive guidance from the SEC highlights the importance of separate presentations of internal and external sources of liquidity (including material unused sources of liquidity), including known trends, commitments, events or uncertainties that are reasonably likely to result in a material change in liquidity. The SEC guidance also makes it clear that, depending on an issuer's circumstances, if borrowings during a reporting period are materially different than period-end amounts, discussion of the intra-period variations is required.[126]

- **Off-Balance Sheet Arrangements** – A discussion of off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on financial condition or results of operations is required.

- **Tabular Disclosure of Contractual Obligations** – A tabular presentation indicating the dollar amount of known contractual obligations and the time periods in which those obligations are payable is required.

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[126] The SEC release is available at http://www.sec.gov/rules/interp/2010/33-9144.pdf.

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21. Changes in and disagreements with accountants

If the issuer's primary outside accounting firm has resigned or been dismissed within the two most recent fiscal years or any subsequent interim period, the issuer must disclose, among other things, whether the accountant's report on the financial statements included an adverse opinion, disclaimer of opinion or certain qualifications, and whether there were any disagreements as to certain accounting matters.

22. Quantitative and qualitative disclosures about market risk

This highly technical item is intended to disclose risks resulting from hedges, derivative contracts and other market risk sensitive instruments.

23. Disclosure and financial controls and procedures

Added as part of the Sarbanes-Oxley reforms, this item requires that the issuer disclose the conclusions of its principal executive officer and its principal financial officer regarding the effectiveness of the issuer's disclosure controls and procedures (*i.e.*, controls designed to ensure that information required to be disclosed in periodic reports filed with the SEC is communicated to management to allow timely decisions regarding required disclosure). The issuer is also required to disclose in a Form 10-K management's assessment of the effectiveness of the issuer's internal control over financial reporting as of the end of the most recent fiscal year, including disclosure of any material weaknesses, and the outside accounting firm is required to provide an attestation report on the issuer's internal control over financial reporting for the applicable fiscal year. In addition, the issuer is required to disclose any material changes in internal control over financial reporting during the most recent fiscal quarter in quarterly Form 10-Q filings. However, an issuer is not required to comply with the requirements regarding internal control over financial reporting until it has filed an annual report for the prior fiscal year, meaning that newly public companies have a certain grace period before they are required to make an effectiveness assessment. On the other hand, as the issuer ultimately will have to comply with these requirements, in preparing for its IPO it should make an effort to ensure that the implementation of these controls will not result in any surprises arising when the second annual report is filed.

24. Directors and executive officers

This item requires a listing of the names and ages of all directors and executive officers, their positions with the issuer, terms of office and periods during which they have served as such, and any arrangements pursuant to which any such person was or is to be selected as a director or officer. Similar information must be submitted for persons nominated or chosen to become directors or executive officers. The issuer must also include a brief description of the business experience of each of these persons during the last five years (typically limited to the names of other companies where the person served or is serving as a director or officer and the position held). In addition, the issuer is required to disclose if any such person has been involved in certain legal proceedings or been subject to certain court decrees (involving, among other things, bankruptcy, criminal proceedings and

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violations of securities or commodities laws) during the past five years that are "material to an evaluation of the ability or integrity of the director or executive officer."

25. Directors and executive officers, compliance with Section 16(a) of the 1934 Act, code of ethics and corporate governance

In addition to information about directors and executive officers described in Item 23 above, annual reports on Form 10-K are also required to disclose, among other things, the following:

- any failure by a director, officer or beneficial owner of more than 10% of any class of equity securities to timely file a report required by Section 16(a) of the 1934 Act (which deals with short-swing profits) and, in the case of any such failure, the number of late reports, the number of transactions not reported and any known failure to file a required report;

- whether the issuer has adopted a code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or an explanation of why no code of ethics has been adopted;

- any material changes to the procedures by which securityholders may recommend nominees to the issuer's board of directors;

- if the issuer has securities listed on a national securities exchange, whether (subject to certain specified exceptions) the issuer has a separately designated standing audit committee and, if so, the name of each member or, if the entire board of directors is acting as an audit committee, a statement to that effect, and if the issuer is relying upon any exemption from the independence standards for audit committee members; and

- if the issuer has an audit committee, the name of any audit committee financial expert or an explanation of why there is no such expert on the audit committee.

26. Executive compensation and corporate governance

The item on executive compensation is typically one of the longest sections in a registration statement on Form S-1 or proxy statement, which is usually incorporated by reference into Form 10-K. The executive compensation disclosure may be incorporated by reference into the issuer's Form 10-K from the issuer's proxy statement if the proxy statement is filed with the SEC not later than 120 days after the end of the fiscal year covered by the issuer's Form 10-K. However, if the issuer does not file the proxy statement with the SEC within the 120-day period, the executive compensation disclosure must be included in the Form 10-K or an amendment to the Form 10-K not later than the end of the 120-day period.

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This item is intended to provide comprehensive disclosure of all compensation paid to each "named executive officer," or "NEO," which is defined to include the principal executive officer, the principal financial officer and the issuer's three most highly compensated executive officers other than the principal executive and financial officers who were serving in that capacity at the end of the most recent fiscal year. Named executive officers may also include up to two additional individuals who would have been included among the three most highly compensated executive officers but for the fact that they were not executive officers as of the end of the most recent fiscal year. The required disclosure includes the following:

- **Compensation discussion and analysis ("CD&A")** – A textual discussion of the compensation awarded to the named executive officers, including objectives of the compensation program and what it is designed to reward, each element of compensation, and how the issuer determines the amount (or the formula) for each element of compensation. This may include disclosing items such as targeted levels of return and other quantitative factors used to determine compensation.

- **Summary compensation table** – A tabular presentation of the compensation of each named executive officer for the last three completed fiscal years, including salary, bonus, stock and option awards, non-equity incentive plan compensation, changes in pension value and non-qualified deferred compensation earnings, and other forms of compensation. The SEC adopted rule changes in 2009 requiring disclosure of the grant date fair value of equity awards in the summary compensation table rather than the dollar amount of compensation expense recognized for financial statement purposes.

- **Grants of plan-based awards table** – A tabular presentation of each award made to a named executive officer in the most recent completed fiscal year, including grants under equity and non-equity incentive plans and other stock and option awards.

- **Important factors to consider** – Narrative description of any material factors necessary to an understanding of the summary compensation table or grants of plan-based awards table.

- **Outstanding equity awards at fiscal year-end table** – For each named executive officer, tabular information concerning unexercised options, unvested shares and equity incentive plan awards at fiscal year end.

- **Option exercises and stock vested table** – A tabular presentation showing, for each named executive officer, exercises of stock options, stock appreciation rights and similar instruments and vesting of restricted stock, restricted stock units and similar instruments during the last completed fiscal year.

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- **Pension benefits table** – A tabular presentation showing, for each named executive officer, the present value of accumulated pension benefits and payments during the last fiscal year.

- **Non-qualified deferred compensation plans** – For each named executive officer, a tabular presentation of contributions to, earnings on, withdrawals from and remaining balance of each defined contribution or other plan that provides for the deferral of compensation on a non-tax qualified basis.

- **Payments upon resignation or termination** – For each agreement or other plan that provides for payment to a named executive officer in connection with termination or resignation (including upon a change of control of the issuer), a description of the circumstances triggering the payment and the amount of the payments.

- **Director compensation table and narrative description** – A tabular presentation of the compensation paid to directors for the most recent completed fiscal year, including fees, stock and option awards and other benefits, as well as a narrative description of material factors necessary to an understanding of the table, such as standard compensation arrangements for directors.

- **Narrative description of risks arising from compensation policies and practices** – To the extent that risks arising from the issuer's compensation policies and practices are reasonably likely to have a material adverse effect on the issuer, disclosure of the issuer's policies and practices of compensating its employees (including non-executive officers) as they relate to risk management practices and risk-taking incentives.

- **Golden parachute compensation table and narrative description** – With respect to a merger proxy statement (including a merger proxy statement prospectus), a tabular presentation of quantitative disclosure of the individual elements of compensation to be received by each named executive officer of the acquiror and the target in connection with the subject acquisition, merger, consolidation, sale or other disposition or all of substantially all assets of the issuer, as well as a narrative description of the golden parachute compensation arrangements.

The issuer must also identify each person who served as a member of the compensation committee (or other committee performing equivalent functions) during the last fiscal year and who was an officer or employee of the issuer during that fiscal year, or was formerly an officer of the issuer or had any relationship with the issuer requiring disclosure as a "related person transaction" (see Item 28 below). The issuer must also disclose any "compensation committee interlocks," such as where one of its executive officers served on the compensation committee of another entity, one of whose executive officers served on the issuer's compensation committee. In the case of an annual report on Form 10-K, the issuer must also include a "compensation committee report" stating whether

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the compensation committee has reviewed CD&A and recommended to the board of directors that it be included in the annual report.

As discussed below under "Disclosure Requirements of Proxy Statements–Item 8," issuers that qualify as EGCs are exempt from certain compensation disclosure requirements under Item 402 of Regulation S-K, and instead must only comply with those provisions of Item 402 that are applicable to smaller reporting companies.

27. Security ownership of certain beneficial owners and management

This item requires disclosure of ownership of the issuer's equity securities by each director and named executive officer, by all directors and executive officers as a group and by each beneficial owner of more than 5% of any class of the issuer's voting securities. The information must be presented in tabular format showing the name of the beneficial owner and the number of securities and the percentage of the class owned. Arrangements that may result in a change in control of the issuer also must be disclosed.

In the case of a Form 10-K, the issuer must provide the following information in tabular format for equity securities issuable under compensation plans, specifying whether or not the securities are authorized for issuance under plans which have been approved by stockholders:

- number of securities issuable upon exercise of outstanding options, warrants and rights,
- weighted-average exercise price per share of outstanding options, warrants and rights, and
- number of securities remaining available for future issuance under equity compensation plans.

28. Related person transactions and director independence

Item 404 of Regulation S-K requires disclosure of transactions in an amount exceeding $120,000 between the issuer and any "related person" since the beginning of the last fiscal year (or, in the case of information in a registration statement on Form S-1, since the beginning of the third prior fiscal year). The required information includes the name of the related person and the approximate dollar value of the transaction, as well as any other material information. A "related person" is defined to include, among others and subject to exceptions, directors, executive officers, beneficial owners of more than 5% of any class of the issuer's voting securities, and immediate family members of any of the foregoing. This item does not require an issuer to disclose compensation paid to executive officers and directors if that compensation is disclosed pursuant to Item 402 of Regulation S-K (see Item 26 above). This item also does not require disclosure of loans made to related persons by banks and certain other lenders in the ordinary course of business and on customary terms.

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If an issuer is filing a registration statement on Form S-1 and has had a "promoter" at any time during the past five fiscal years, the registration statement must name the promoter and describe the nature and amount of anything of value received by the promoter, directly or indirectly, from the issuer and the nature and amount of any assets, services or other consideration received by the issuer from the promoter. If the issuer is a "shell company," similar information is required with respect to transactions between the issuer and any person or group controlling the issuer.

This item also requires a description of the issuer's policies and procedures for reviewing and approving related person transactions. The issuer must also identify which, if any, of the related person transactions disclosed in response to this item were not subject to review or approval or where the review and approval policies and procedures were not followed.

Finally, Item 407(a) of Regulation S-K requires that the issuer identify each director who is independent under applicable director independence standards and, if those standards also require that committees include one or more independent directors, the issuer must identify each member of the compensation, nominating or audit committee that is not independent. For issuers whose securities are listed (or, in the case of IPOs, will upon completion of the offering be listed) on a national securities exchange, the relevant independence standards are those of the applicable stock exchange. If the issuer is taking advantage of any available exceptions to the director or committee independence standards, those exceptions must be described. Finally, the issuer must describe any transaction between the issuer and any director that was not disclosed pursuant to Item 404 of Regulation S-K (see above) that was considered by the board of directors under the applicable independence standards in determining whether the director is independent.

29. Material changes in procedures for nominating directors

The issuer must describe any material changes to the procedures by which stockholders may recommend nominees to the board of directors that have been implemented since the last time the issuer provided disclosure regarding such procedures.

30. Risk factors

The risk factors section is intended to highlight for investors in plain English, in a concise and organized manner, the material risks and uncertainties affecting the issuer's business, as well as any risks specific to the types of securities that are being offered. Although the SEC's position is that the risk factors section should be limited to those risks that are specific to the issuer (rather than risks that are shared generally by other companies in the same business), the risk factors nonetheless typically describe a combination of both issuer-specific and more general risks. Although not legally required, an effort often is made to list risks to some extent in the order of their perceived importance.

The risk factors discussion has grown substantially and, especially with IPOs or companies that recently went public, may be one of the longest sections of the prospectus and

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a significant focus of SEC comments. Risk factors often include (1) disclosures relating to the businesses in which the issuer operates, (2) risks relating to the issuer's operations, such as dependence on key executives, dependence on key suppliers or customers, leverage and material litigation and (3) risks relating to the terms of the offered securities or, in the case of equity securities, provisions of the issuer's charter or bylaws.

The risk factors section is one of the most important elements of an issuer's disclosure for liability purposes and also may be read carefully by certain investors. Careful attention should be given to considering what changes should be made to existing disclosure to keep it up to date, including what new risks may merit disclosure and the potential deletion of risk factors that are no longer believed to be material. For example, recent guidance released by the SEC[127] highlights the importance of discussing cyber security risks in an issuer's risk factors disclosure (as well as cyber security incidents and issues in other sections of the prospectus or annual report) to the extent these issues are of importance to the issuer. Defendants in securities litigation often point to the risk factors disclosure, and such disclosure has been persuasive in a number of cases, such as in having cases dismissed at a relatively early stage.

For IPOs, the risk factors disclosure must be physically included in the prospectus. For issuers that are entitled to incorporate information into a registration statement by reference to their periodic reports filed with the SEC, risk factors may either be incorporated by reference or physically included in the prospectus, or both. For reporting companies, it is not uncommon to incorporate by reference the company-specific risk factors appearing in reports filed with the SEC, and to supplement those with offering- or security-specific risk factors that are physically included in the prospectus.

31. Recent sales of unregistered securities; use of proceeds from sale of registered securities

This item requires the issuer to disclose certain information about any of its securities that have been sold or issued in exchange for property, services or other securities (for example, stock options issued in exchange for services) without registration under the 1933 Act. In the case of registration statements on Form S-1, this information must be provided for the past three fiscal years and is included in Part II of the registration statement. In the case of annual reports on Form 10-K, this information must be provided only with respect to equity securities sold or issued during the period covered by the report unless previously disclosed in a quarterly report on Form 10-Q or a current report on Form 8-K. Likewise, in the case of a quarterly report on Form 10-Q, this information is only required for equity securities sold during the period covered by the report that have not been previously reported in a current report on Form 8-K.

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[127] The SEC guidance is available at http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm.

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This item also requires the first Form 10-K or 10-Q filed by an issuer following the effective date of its first registration statement to include information regarding, among other things, the amount of proceeds from the offering and how they were applied, and subsequent annual and quarterly reports must update that information. These requirements terminate after the issuer has disclosed how it has used all of the offering proceeds.

32. Repurchases of equity securities

This item requires tabular disclosure of any purchases made by the issuer of any of its equity securities that are listed on a national securities exchange or otherwise registered under Section 12 of the 1934 Act. This information includes the number of shares purchased, the average price paid and, in the case of purchases pursuant to a publicly announced repurchase plan, the number of shares (or dollar amount) that remains to be purchased under the plan. This information must be provided for each month of the quarter covered by a Form 10-Q or for each month of the fourth quarter of the fiscal year covered by a Form 10-K.

33. Material changes in the issuer's business since the end of the latest fiscal year covered by audited financials that have not been described in a document incorporated by reference

This item requires that the issuer disclose in a registration statement any material changes in its business that have occurred since the end of the fiscal year covered by its latest audited financial statements, unless that information has been disclosed in a Form 10-Q or Form 8-K that is incorporated by reference into the registration statement. This requirement applies to registration statements on Form S-1 where the issuer is eligible and elects to incorporate by reference information from its annual and quarterly reports filed with the SEC and to all registration statements on Form S-3.

34. Incorporation by reference

This item specifies the information that must be incorporated by reference into a registration statement on Form S-1 (assuming that the issuer is eligible to incorporate by reference and elects to do so) and in a registration statement on Form S-3.

An issuer filing a Form S-1 may incorporate documents by reference if, among other things, it is subject to the reporting requirements of the 1934 Act, has filed all required reports and materials during the past twelve months and has filed an annual report for its most recently completed fiscal year. In that case, an issuer electing to incorporate by reference must incorporate its latest Form 10-K and all filings on Forms 10-Q and 8-K and all proxy and information statements filed pursuant to Sections 13(a), 14 or 15(d) of the 1934 Act since the end of the fiscal year covered by such Form 10-K. However, Form S-1 does not permit the issuer to incorporate by reference filings made subsequent to the date of the registration statement (so-called forward incorporation).

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Registration statements on Form S-3 require the issuer to incorporate its most recent annual report on Form 10-K and all other reports on Form 10-Q and Form 8-K filed pursuant to Section 13(a) or 15(d) of the 1934 Act since the end of the fiscal year covered by such annual report. Unlike Form S-1, Form S-3 also provides that all subsequent filings made by the issuer pursuant to Sections 13(a), 13 (c), 14 or 15(d) of the 1934 Act prior to the termination of the offering are automatically deemed to be incorporated by reference. As a result, updating information is automatically incorporated by reference to filings made under the 1934 Act. If a registration statement on Form S-3 is registering capital stock of a class that is also registered under Section 12 of the 1934 Act (such as common stock listed on a securities exchange), the description of that capital stock may be incorporated by reference to a registration statement filed under the 1934 Act. However, most issuers choose to include the description of capital stock in a registration statement on Form S-3 rather than incorporating it by reference.

In the case of both registration statements on Forms S-1 and S-3, issuers are not required to incorporate by reference information that is deemed to have been "furnished" to, rather than "filed" with, the SEC. In that regard, quarterly earnings information filed under Item 2.02 of Form 8-K and information that the issuer elects to file under Item 7.01 of Form 8-K to comply with Regulation FD is deemed to be "furnished" and not "filed." This means that issuers and underwriters will not be subject to 1933 Act liability for information that is "furnished" to the SEC unless the issuer expressly incorporates that information by reference into the applicable registration statement.

35. Unresolved SEC staff comments

An annual report on Form 10-K must disclose the substance of any material unresolved SEC comments under the following circumstances:

- the issuer is an "accelerated filer" or "large accelerated filer" (as defined in Rule 12b-2 of the 1934 Act) or a "well-known seasoned issuer" (as defined in Rule 405 of the 1933 Act);

- the issuer received SEC comments regarding its periodic or current reports not less than 180 days before the end of the fiscal year to which the Form 10-K relates; and

- those comments remain unresolved.

In that case, the issuer must disclose the substance of any comments that it believes are material, but the issuer may also include its view regarding those comments.

36. Defaults upon senior securities

A quarterly report on Form 10-Q must disclose if there has been a material default in the payment of any amount due, or any other material default that was not cured within thirty days, with respect to any indebtedness of the issuer or any of its significant subsidiaries if

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that indebtedness exceeds five percent of the issuer's consolidated assets. However, this only applies to events which have become defaults after the expiration of any grace period and compliance with any notice requirements.

This item also requires disclosure of any material arrearage in the payment of dividends, or any other material delinquency not cured within thirty days, with respect to any preferred stock of the issuer that is registered or that ranks prior to any class of the issuer's registered securities (typically common stock) or with respect to any preferred stock of any significant subsidiary of the issuer.

The foregoing information may be omitted if it has been previously disclosed on Form 8-K.

Although Form 10-K does not contain an analogous provision to Form 10-Q requiring the disclosure of such material defaults, material arrearages or material delinquencies, if any of those events were to occur in the fourth quarter of an issuer's fiscal year, disclosure of those events would typically be contained in the issuer's Form 10-K for the fiscal year containing that fourth quarter.

37. Other information not disclosed in a report on Form 8-K

The issuer must disclose in a Form 10-K or 10-Q any information that the issuer should have reported in a current report on Form 8-K during the fourth quarter of the fiscal year covered by the Form 10-K or the period covered by the Form 10-Q, respectively, but that was not reported under Form 8-K as required.

38. Principal accounting fees and services

This item requires that the issuer disclose the amount paid to its principal accountant for each of the last two fiscal years for audit services, audit-related services, tax services and all other services, in addition to certain related information.

39. Financial statements

Form 10-K

An annual report on Form 10-K generally must include audited balance sheets as of the end of the two most recent fiscal years and audited statements of income, cash flow and changes in stockholders' equity for each of the three most recent fiscal years.

Form 10-Q

Quarterly reports on Form 10-Q must include the following unaudited financial statements:

- Balance sheet as of the end of the most recent quarter and as of the end of the preceding fiscal year;

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- Statements of income for the most recent quarter and, in the case of the second or third quarter Form 10-Q, statements of income for the six or nine months, as the case may be, then ended, together with statements of income for the same period or periods, as the case may be, in the prior fiscal year; and

- Statements of cash flow for the period after the end of the preceding year through the end of the most recent fiscal quarter and for the same period in the prior fiscal year.

The interim financial statements included in quarterly reports on Form 10-Q must be reviewed by an independent public accounting firm in accordance with applicable professional standards. However, this review does not constitute an audit and no report of the independent accounting firm is required.

Form S-1

Registration statements on Form S-1 generally must include:

- audited balance sheets for the two most recent fiscal years;

- audited statements of income, cash flows, and changes in stockholders' equity for the three[128] most recent fiscal years;

- an unaudited balance sheet as of the end of the most recent quarterly period; and

- unaudited statements of income, cash flows and changes in stockholders' equity for the period from the end of the most recent fiscal year through the end of the most recent fiscal quarter, together with unaudited statements of income, cash flows and changes in stockholders' equity for the same period in the prior fiscal year.

In addition, a registration statement on Form S-1 must include pro forma financial statements if, among other things, the issuer has completed a "significant" acquisition since the beginning of the last fiscal year or such an acquisition is probable, or the disposition of a "significant" portion of the issuer's business has occurred or is probable and that disposition is not reflected in the issuer's financial statements.

The disposition of a business is generally considered "significant" if:

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[128] As discussed below under "Reduced Disclosure Requirements for EGCs," companies that qualify as EGCs are only required to present two years of audited financial statements.

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- the issuer's consolidated investments in and advances to the business exceeded 10% of the issuer's total consolidated assets as of the end of the most recent fiscal year;

- the issuer's proportionate share of the total assets of the business (after intercompany eliminations) exceeded 10% of the issuer's total consolidated assets as of the end of the most recent fiscal year; or

- the issuer's equity in income from continuing operations after income taxes, extraordinary items and cumulative effect of a change in accounting principle of the business (exclusive of amounts attributable to any non-controlling interest) exceeded 10% of such consolidated income of the issuer for the most recently completed fiscal year.

A completed or probable acquisition is generally considered "significant" based on the same tests, but substituting 20% for 10%.

A registration statement on Form S-1 also must include historical financial statements for any business acquired by the issuer or whose acquisition is probable under the following circumstances:

- If none of the tests described in the preceding paragraph exceeds 20%, financial statements of the acquired business are not required. However, if the aggregate impact of individually insignificant businesses acquired since the date of the issuer's most recent audited balance sheet exceeds 50%, historical financial statements covering at least the substantial majority of the acquired businesses must be included in the registration statement. Those financial statements must include, at a minimum, audited financial statements for the most recent fiscal year and unaudited statements for any subsequent interim period;

- If any of the conditions set forth in the preceding paragraph exceeds 20% but none exceeds 40%, the registration statement must include the acquired businesses' audited financial statements for the most recent fiscal year and unaudited financial statements for any subsequent interim period;

- If any of the conditions exceeds 40% but none exceeds 50%, the registration statement must include the acquired businesses' audited financial statements for the two most recent fiscal years and unaudited financial statements for any subsequent interim period; and

- If any of the conditions exceeds 50%, then full audited financial statements for the acquired business are required, together with unaudited financial statements for any subsequent interim period. However, 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 were less than $50 million.

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There are several exceptions to the requirement to include historical financial statements of acquired businesses and pro forma financial statements giving effect to the acquisition in registration statements. Pro forma financial statements with respect to the acquisition are not required to be presented if separate historical financial statements of the acquired business are not included in the registration statement. Historical financial statements of acquired businesses may be omitted from a registration statement if none of the conditions set forth above exceeds 50% and either (i) the acquisition has not yet occurred or (ii) the date of the final prospectus is not more than seventy-four days after the consummation of the acquisition and financial statements of the acquired business have not been previously filed by the issuer. Likewise, separate financial statements of an acquired business are not required once the operating results of that business have been reflected in the issuer's audited financial statements for a complete fiscal year, unless those financial statements have not been previously filed or unless the acquired business is of such significance that omission of those financial statements would materially impair an investor's ability to understand the issuer's historical financial results. A separate audited balance sheet of the acquired business is not required when the issuer's most recent audited balance sheet is for a date after the date the acquisition was consummated.

See Chapter 19 (*Acquisition Finance in the Capital Markets*) for a further discussion of financial statement requirements in connection with a pending or completed acquisition.

Form S-3

Registration statements on Form S-3 generally must include the same issuer financial statements, as well as pro forma financial statements and financial statements of acquired businesses, as registration statements on Form S-1, except that the issuer may incorporate those financial statements by reference. Form S-3 also requires the inclusion of restated financial statements if there has been a change in accounting principle or correction of an error where such change or correction requires a material retroactive restatement and any financial information required because of a material disposition of assets outside the normal course of business.

XBRL Filings

As discussed in Chapter 7 (*Ongoing Reporting and Other Requirements*) under the heading "Extensible Business Reporting Language (XBRL)," recent rules adopted by the SEC now require all issuers to file additional versions of their financial statements prepared with XBRL, an interactive data technology that uses unique tags to identify individual items in an issuer's financial statements so they are more searchable and more readable by spreadsheets and other comparative and analytical tools used by investors and financial analysts. Subject to certain exceptions, XBRL financial statements must be filed as a separate exhibit to all annual reports on Form 10-K, 20-F or 40-F, all quarterly reports on Form 10-Q, all current reports on Form 8-K or 6-K that contain revised or updated annual or interim financial statements and all registration statements, such as on Forms S-1 or F-1, except registration statements used in the context of an initial public offering and Form S-3

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registration statements that incorporate financial statements by reference but do not directly contain or attach financial statements.

40. Expenses of issuance and distribution

Part II of a registration statement on Form S-1 or S-3 requires a statement of expenses incurred by the issuer in connection with the registration and issuance of the securities in question, other than underwriting discounts and commissions, but including any expenses incurred by selling securityholders that are payable by the issuer. This information is typically presented in tabular format and covers items such as the SEC registration fee, any FINRA filing fees, accounting and legal fees, fees of trustees and transfer agents, and rating agency fees. In the case of a shelf registration statement, only expenses that are known at the time of filing should be included.

41. Undertakings

Part II of a registration statement on Form S-1 or S-3 must include certain undertakings (effectively agreements by the issuer) that are required by SEC rule. In particular, if the issuer plans to seek acceleration of the registration statement's effective date or if the registration statement is an automatic shelf registration statement that will become effective automatically, the issuer must undertake that, if a claim for indemnification for liabilities arising under the 1933 Act is asserted against the issuer by a director, officer or controlling person (other than a claim for the payment of expenses incurred in the successful defense of such claim), the issuer will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to an appropriate court the question of whether indemnification by the issuer is against public policy as expressed in the 1933 Act and to be governed by the final adjudication of that issue.

42. Exhibits

Item 601 of Regulation S-K specifies documents that the issuer must file or incorporate by reference as exhibits to a Form 10-K, 10-Q, S-1 or S-3. Each of those reports and registration statements must also include a list of the exhibits, although, in the case of registration statements, the list is included in Part II. One of the more significant requirements is that the issuer file copies of its material contracts. Exhibits filed with the SEC are publicly available and issuers may therefore be concerned about filing contracts that include sensitive commercial information. In those cases, the issuer may submit a confidential treatment request to the SEC, and SEC comments regarding the request must be resolved before a registration statement will be declared effective or a periodic report is filed. If the request is granted, the SEC will typically still require that the contract be filed, but will permit the issuer to redact confidential information.[129]

[129] See SEC SLAB No. 1A.

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As part of the Sarbanes-Oxley reforms, issuers are required to include as exhibits to each Form 10-K and Form 10-Q two separate certifications by each principal executive officer and principal financial officer of the issuer (a) regarding disclosure controls and procedures and internal control over financial reporting and (b) regarding whether the report complies with the requirements of Section 13(a) or Section 15(d) of the 1934 Act and that the report presents fairly, in all material respects, the financial condition and results of operations of the issuer.

43. Recent sales of unregistered securities

Part II of a registration statement on Form S-1 requires that the issuer disclose certain information about securities that have been issued without registration under the 1933 Act during the past three fiscal years. For more information, see Item 30 above.

44. Indemnification of directors and officers

Part II of a registration statement on Form S-1 or Form S-3 must include a general description of any statute, charter or bylaw provision, contract or other arrangement under which any director, officer or controlling person of the issuer is insured or indemnified in any manner against liability which may be incurred in such capacity. This information typically takes the form of a brief discussion of indemnification provisions under applicable corporate law, the issuer's charter and bylaws, insurance policies, indemnification agreements by the issuer, and underwriting, distribution and similar agreements.

45. Financial statement schedules

Financial statement schedules required by Regulation S-X must be filed as part of an annual report on Form 10-K or in Part II of a registration statement on Form S-1.

46. Supplemental information required for issuers which have not registered securities pursuant to Section 12 of the 1934 Act

Certain additional information must be supplied with an annual report on Form 10-K if the issuer has not registered securities pursuant to Section 12 of the 1934 Act. In those cases, the issuer must also furnish to the SEC, at the time that its Form 10-K is filed, any annual report provided to its securityholders or any proxy statement or other proxy materials sent to more than ten of its securityholders with respect to any meeting.

SIGNATURES AND CERTIFICATIONS

Form S-1, Form S-3 and other forms of registration statements under the 1933 Act and Form 10-K must be signed by the issuer, its principal executive officer or officers, its principal financial officer, its controller or principal accounting officer, and by at least a majority of the board of directors or persons performing similar functions.

Form 10-Q must be signed on behalf of the issuer by any duly authorized officer and by the principal financial or chief accounting officer. Two separate provisions of Sarbanes-

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Oxley require the principal executive and financial officers of each reporting company to personally certify the accuracy of periodic reports filed with the SEC.

Sarbanes-Oxley Section 906 amended the federal criminal code to require certifications of all periodic reports containing financial statements filed with the SEC. The certification may be a single certification by both officers. It must state that the report fully complies with the statutory requirements of the 1934 Act and that the information in the report "fairly presents, in all material respects, the financial condition and results of operations of the issuer." Although the SEC has only limited power to change or interpret the Sarbanes-Oxley Section 906 certification requirement, it has acted to require that the Section 906 certification be "furnished" to (rather than "filed" with) the SEC as an exhibit to Form 20-F.[130]

Sarbanes-Oxley Section 302 required the SEC to adopt rules to require the principal executive and financial officers of each issuer filing annual or quarterly reports to make separate certifications regarding these reports. As implemented by the SEC, the Sarbanes-Oxley Section 302 certifications are to be "filed" with the SEC (rather than "furnished") as exhibits to the related report. The content of the required certifications (which must be "exactly" as specified by the SEC) may be summarized as follows:

- the signer has reviewed the report;
- based on the signer's knowledge, the report does not contain an untrue statement of material fact or omit to state a material fact necessary to make the statements, in light of the circumstances under which the statements were made, not misleading with respect to the period covered by the report;
- based on the signer's knowledge, the financial statements and other financial information in the report fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of and for the periods presented in the report;
- the signer and the other certifying officer are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the issuer and have:
    - designed such disclosure controls and procedures or caused them to be designed under their supervision to ensure that material information is made known to the certifiers;

[130] Documents that are "furnished" to, rather than "filed" with, the SEC are not automatically incorporated by reference in an issuer's Form S-3 registration statement. They also entail different liabilities under the U.S. securities laws, as discussed in Chapter 16 (*Liabilities Under U.S. Securities Laws*).

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  - designed such internal control over financial reporting or caused it to be designed under their supervision to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

  - evaluated the effectiveness of such disclosure controls and procedures and presented the signer's conclusions about such effectiveness; and

  - disclosed any change in internal control over financial reporting that occurred during the period covered by the report that has materially affected or is reasonably likely to materially affect the issuer's internal control over financial reporting;

- the signer and the other certifying officer have disclosed to the issuer's auditors and audit committee all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the issuer's ability to record, process, summarize and report financial information and any fraud (whether or not material) involving management or other employees with a significant role in the issuer's internal control over financial reporting.

REDUCED DISCLOSURE REQUIREMENTS FOR EGCs

EGCs are exempted from certain disclosure requirements for their registration statements, proxy statements, annual reports and periodic reports and are afforded special privileges in connection with their public securities offerings. In particular, EGCs are:

- required to present only two (as opposed to three) years of audited financial statements and related MD&A discussion in any registration statement, annual report or periodic report (which reduced disclosure requirements have been interpreted by the SEC to also apply to the financial statements of acquired companies required to be included);

- not required to present selected financial data in any registration statement, annual report or periodic report for periods preceding the earliest audited period in its IPO registration statement (so long as earlier data is not required to prevent the disclosure from being misleading);

- exempt from the Sarbanes-Oxley Section 404(b) auditor attestation requirement (which can be burdensome both in terms of cost and management time) relating to internal control over financial reporting (however, EGCs are still required to present management's assessment and conclusions regarding the effectiveness of internal controls and procedures);

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- grandfathered from compliance with new or revised financial accounting or auditing standards for public companies enacted after the date of the JOBS Act, unless the SEC determines the new rules are necessary to protect the public;

- exempt from certain compensation disclosure requirements under Item 402 of Regulation S-K and instead must only comply with the requirements of Item 402 applicable to smaller reporting companies, meaning that the issuer may omit the CD&A section and present compensation information for two (rather than three) years and three (rather than five) named executive officers;

- exempt from Section 14A(a) and (b) of the 1934 Act, implemented by Section 951 of the Dodd-Frank Act, which require issuers to hold stockholder advisory votes on executive compensation and golden parachute compensation; and

- exempt from pending Dodd-Frank Act requirements to provide "pay-versus-performance" disclosure (showing the relationship between executive compensation paid and financial performance of the issuer) and the ratio of CEO compensation to median employee compensation.

The EGC provisions are flexible, so that the issuer may elect to avail itself of the ability to use reduced disclosure as to some items but not others. For example, it may decide to include three years of audited financial information and selected financial information and MD&A disclosure while electing to have reduced executive compensation disclosure. Experience with these provisions is limited. However, the cost savings to an issuer from taking advantage of the reduced EGC disclosure requirements may be significant, both in terms of out-of-pocket costs and management time.

CURRENT REPORTS: DISCLOSURE AND SIGNING REQUIREMENTS OF FORM 8-K

An "S" filer is required to file current reports on Form 8-Ks to announce material corporate events that its stockholders should know about. Form 8-K may also be used by an issuer to disclose certain nonpublic information required by Regulation FD or to satisfy its filing obligations pursuant to Rule 425 under the 1933 Act, regarding written communications related to business combination transactions, or Rules 14a-12(b) or Rule 14d-2(b) under the 1934 Act, relating to soliciting materials and pre-commencement communications pursuant to tender offers, respectively.

For a detailed chart of events that trigger a reporting obligation on Form 8-K, see Appendix F. In summary, when used as a current report, Form 8-K must be filed by an issuer within four business days of the occurrence of any of the following events:

(1) entry into a material definitive agreement;

(2) termination of a material definitive agreement;

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(3) bankruptcy or receivership;

(4) receipt of certain shutdown orders and notices of patterns or potential patterns of violations from the U.S. Department of Labor's Mine Safety and Health Administration;

(5) completion of acquisition or disposition of assets;[131]

(6) public announcement or release (including any update of an earlier announcement or release) disclosing material non-public information regarding the issuer's results of operations or financial condition for a completed quarterly or annual fiscal period;

(7) creation of a material direct financial obligation or a material obligation under an off-balance sheet arrangement of the issuer;

(8) an event that accelerates or increases a direct financial obligation or an obligation under an off-balance sheet arrangement of the issuer, where the consequences of such event are material;

(9) exit or disposal plan of the issuer under which material charges will be incurred under GAAP;

(10) material charge for impairment to one or more of the issuer's assets (including, without limitation, impairments of securities or goodwill) is required under GAAP;

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[131] Financial statements of businesses acquired and related pro forma financial information will be required to be furnished as part of the Current Report on Form 8-K. Item 9.01 of Form 8-K requires that these financial statements be filed not later than 71 calendar days plus four business days after the date on which the acquisition was consummated. However, the SEC has indicated that, if the significance level of the completed acquisition exceeds 50%, issuers should not make offerings pursuant to effective registration statements, and new registration statements and post-effective amendments to existing registration statements will not be declared effective (and WKSIs should not make offerings pursuant to newly effective automatic shelf registration statements), unless the required financial statements have been filed. In addition, offerings should not be made pursuant to effective registration statements, or pursuant to Rules 505 and 506 of Regulation D (17 CFR 230.505 and 230.506) where any purchasers are not accredited investors under Rule 501(a) of that Regulation, until the audited financial statements required by Rule 3-05 of Regulation S-X (17 CFR 210.3-05) are filed; provided, however, that the following offerings or sales of securities may proceed notwithstanding that financial statements of the acquired business have not been filed: (a) offerings or sales of securities upon the conversion of outstanding convertible securities or upon the exercise of outstanding warrants or rights, (b) dividend or interest reinvestment plans, (c) employee benefit plans, (d) transactions involving secondary offerings, or (e) sales of securities pursuant to Rule 144 (17 CFR 230.144).

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(11) notice of delisting or failure to satisfy a continued listing rule or standard of a national securities exchange or national securities association or a transfer of listing, in each case, in respect of a class of the issuer's common equity;

(12) unregistered sales of equity securities;

(13) material modification to rights of the holders of any class of registered securities of the issuer;

(14) change in the issuer's certifying accountant;

(15) non-reliance on the issuer's previously issued financial statements or a related audit report or completed interim review;

(16) changes in control of the issuer;

(17) departure of directors or certain officers, election of directors and appointment of certain officers;

(18) amendments to articles of incorporation or bylaws or change in fiscal year;

(19) temporary suspension of trading under the issuer's employee benefit plans;

(20) amendments to the issuer's code of ethics, or waiver of a provision of the code of ethics;

(21) change in shell company status;

(22) submission of matters to a vote of security holders;

(23) shareholder director nominations;

(24) informational and computational materials;[132]

(25) change of servicer or trustee;[133]

(26) change in credit enhancement or other external support;[134]

(27) failure to make a required distribution;[135] and

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[132] These events are applicable only to an issuer of asset-backed securities.

[133] *Id.*

[134] *Id.*

[135] *Id.*

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(28) with respect to asset-backed securities, if any material pool characteristic of the actual asset pool at issuance differs by 5% or more (other than as a result of the pool assets converting into cash in accordance with their terms) from the description of the asset pool in the prospectus filed for the offering pursuant to the 1933 Act.[136]

If an issuer is furnishing information on a Form 8-K solely to satisfy its obligations under Regulation FD to disclose nonpublic information, then it must file the 8-K within the time period set out in Regulation FD. If an issuer intends to make a public announcement of the appointment of a new officer other than by means of a Form 8-K, it may delay filing the Form 8-K filed under item (17) above until the day it makes the public announcement.

The information in a Form 8-K and related exhibits, other than those furnished in connection with the event described in item (6) above or in connection with the issuer's obligations under Regulation FD to disclose nonpublic information, are considered "filed" for purposes of Section 18 of the 1934 Act and are subject to the liability provisions of that Section. See Chapter 16 (*Liabilities Under U.S. Securities Laws*) for a description of liabilities under the 1934 Act.

Form 8-K may be signed on behalf of the issuer by any duly authorized officer.

DISCLOSURE REQUIREMENTS OF PROXY STATEMENTS

Regulation 14A and Schedule 14A thereunder provide detailed instructions as to the disclosure required to be included in the proxy materials delivered to the stockholders of an issuer with a class of equity securities registered pursuant to Section 12 of the 1934 Act.[137]

The following is a summary of the significant information required by Schedule 14A to be included in an issuer's proxy statement. The information to be provided varies according to what action will be taken at the meeting for which a proxy is being solicited. For example, if a significant corporate transaction is being voted upon, additional information with respect to the transaction must be disclosed.

Schedule 14A

Item 1. Date, Time and Place Information.

The proxy statement must state the date, time and place of the meeting of stockholders, and the mailing address of the principal executive offices of the issuer. If action is to be taken by written consent, the proxy statement must state the date by which

[136] *Id.*

[137] See Regulation 14A under The Exchange Act (17 CFR 240.14a-1 to 240.14b-2) and Schedule 14A (17 CFR 240.14a-101).

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consents are to be submitted (if state law requires that such a date be specified or if the person soliciting intends to set a date). The first page of the proxy statement must state the approximate date on which the proxy statement and form of proxy are first being sent to stockholders. In addition, the proxy statement must include the following dates:

- The deadline for submitting stockholder proposals for inclusion in the proxy statement and form of proxy for the issuer's next annual meeting (calculated pursuant to Rule 14a-8(e)); and
- The date after which notice of a stockholder proposal submitted outside the Rule 14a-8 process will be considered untimely (calculated pursuant to Rule 14a-4(c)(1) or as established by the issuer's advance notice provision, if any, authorized by applicable state law).

Item 2. Revocability of Proxy.

The proxy statement must state whether or not the person giving the proxy has the power to revoke it. If the right of revocation is limited or subject to compliance with any formal procedures, the proxy statement must briefly describe such limitation or procedures.

Item 3. Dissenters' Rights of Appraisal.

Under applicable state law, certain corporate actions (*e.g.*, a merger) may require that stockholders who vote against the action be accorded appraisal rights. The proxy statement must, when applicable, outline briefly the rights of appraisal or similar rights of dissenters with respect to any matter to be acted upon and indicate any statutory procedure required to be followed by dissenting stockholders in order to perfect such rights. Where the rights may be exercised only within a limited time after the date of adoption of a proposal, the proxy statement must indicate whether stockholders will be notified of the date that triggers any deadline for exercise. In addition, the proxy statement must indicate (i) whether a stockholder's failure to vote will constitute a waiver of appraisal or similar rights and (ii) whether a stockholder's vote against a proposal will be deemed to satisfy any applicable notice requirements under state law.

Item 4. Persons Making the Solicitation.

For solicitations relating to an uncontested election of directors, the proxy statement must:

- State that the issuer is making the solicitation or, if not, so state and identify the participants in the solicitation;
- Name any director who has informed the issuer of an intention to oppose any proposal and identify the relevant proposal;
- Describe the methods of solicitation if other than by mail or e-proxy;

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- If proxy solicitors are engaged, disclose the material terms of their engagement, including the costs thereof; and

- Identify who will bear the direct or indirect costs of solicitation.

For solicitations relating to a contested election of directors, the proxy statement must:

- State who is making the solicitation;

- Describe the methods of solicitation;

- Describe any class or classes of employees to be used to solicit proxies, and the manner and nature of their employment for such purpose;

- If proxy solicitors are engaged, disclose the material terms of their engagement, including the costs thereof, and, if applicable, the approximate number of specially engaged employees or other persons (naming such other persons) who will solicit stockholders;

- Identify who will bear the costs of solicitation (if such cost is to be borne initially by any person other than the issuer, state whether reimbursement will be sought from the issuer, and, if so, whether the question of such reimbursement will be submitted to a vote of stockholders);

- State the total amount estimated to be spent and the total expenditures to date in connection with the solicitation of stockholders; and

- If any solicitation is terminated pursuant to a settlement between the issuer and any other participant in such solicitation, describe the terms of such settlement, including the cost to the issuer.

Item 5. Interest of Certain Persons in Matters to Be Acted Upon.

For solicitations relating to an uncontested election of directors, the proxy statement must briefly describe any substantial interest, direct or indirect, by security holdings or otherwise, of each of the following persons in any matter to be acted upon (other than elections to office):

- If the solicitation is made on behalf of the issuer, each person who has been a director or executive officer of the issuer at any time since the beginning of the last fiscal year;

- If the solicitation is made otherwise than on behalf of the issuer, each participant in the solicitation;

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- Each nominee for election as a director of the issuer; and
- Each associate of any of the foregoing persons.

For solicitations relating to a contested election of directors, the proxy statement must describe any substantial interest, direct or indirect, by security holdings or otherwise, of each participant in any matter to be acted upon at the meeting, and include with respect to each participant the following information, or a fair and accurate summary thereof:

- Name and business address of the participant;
- The participant's principal occupation or employment and the name, principal business and address of any corporation or other organization in which such employment is carried on;
- Whether or not, during the past ten years, the participant has been convicted in a criminal proceeding (excluding traffic violations or similar misdemeanors) and, if so, give specified details;
- The amount of each class of securities of the issuer which the participant owns beneficially or of record, directly or indirectly;
- The amounts and dates of all purchases and sales of such securities within the past two years;
- The amount of the indebtedness as of the latest practicable date if any part of the purchase price for such shares was borrowed or obtained, and a brief description of the transaction, including the names of the parties involved, if such funds were borrowed or obtained otherwise than pursuant to a margin account or bank loan in the regular course of business of a bank;
- Whether or not the participant is, or was within the past year, a party to any contract, arrangements or understandings with any person with respect to any securities of the issuer and, if so, provide the names of the parties to such contracts, arrangements or understandings and the details thereof;
- The amount of securities of the issuer owned beneficially, directly or indirectly, by each of the participant's associates and the name and address of each such associate;
- The amount of each class of securities of any parent or subsidiary of the issuer which the participant owns beneficially, directly or indirectly;
- Details of any transaction involving any participant or its associates, on the one hand, and the issuer, on the other hand, in which the amount involved exceeds

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$120,000 and which occurred since the beginning of the issuer's last fiscal year or is currently proposed; and

- Details regarding any arrangements or understandings involving any participant or its associates with respect to any future employment by the issuer or its affiliates; or with respect to any future transactions to which the issuer or any of its affiliates will or may be a party.

For solicitations relating to a contested election of directors, the proxy statement also must describe any substantial interest, direct or indirect, by security holdings or otherwise, that any person, other than a director or executive officer of the issuer acting solely in that capacity, who is a party to an arrangement or understanding pursuant to which a nominee for election as director is proposed to be elected, has in any matter to be acted upon at the meeting, and provide:

- Details of any transaction involving such person or its associates, on the one hand, and the issuer, on the other hand, in which the amount involved exceeds $120,000 and which occurred since the beginning of the issuer's last fiscal year or is currently proposed; and

- Details regarding any arrangements or understandings involving any such person or its associates with respect to any future employment by the issuer or its affiliates; or with respect to any future transactions to which the issuer or any of its affiliates will or may be a party.

Finally, for solicitations relating to a contested election of directors made on behalf of the issuer that include disclosure under Item 14 below, the proxy statement must also include disclosure about golden parachute compensation arrangements as required by Item 402(t) of Regulation S-K.

Item 6. Voting Securities and Principal Holders Thereof.

The proxy statement must include:

- The number of outstanding shares of each class of voting securities of the issuer entitled to be voted at the meeting and the number of votes to which each class is entitled;

- The record date, if any, with respect to the annual meeting;

- If action is to be taken with respect to the election of directors and the stockholders have cumulative voting rights, (a) a statement that stockholders have such rights, (b) a brief description of such rights and any conditions to their exercise, and (c) whether discretionary authority to cumulate votes is solicited; and

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- If the issuer has undergone a change in control since the beginning of its last fiscal year, certain specified information concerning such change in control.

In addition, the proxy statement must include a table setting forth the amount and nature of beneficial ownership of each class of the issuer's equity securities by each of the following persons:

- Persons known to be the beneficial owners of more than 5% of any class of the issuer's voting securities (including business or home address);
- Directors and director nominees;
- Named executive officers; and
- Directors and executive officers as a group, without naming them.

The issuer also must indicate by footnote to the table the amount of shares with respect to which a person (x) has the right to acquire beneficial ownership or (y) has pledged as security. Finally, the proxy statement must include a description of any arrangement, including any pledge of securities, which might result in a change of control of the issuer.

Item 7. Directors and Executive Officers.

If action is to be taken with respect to the election of directors, the following information must be included in the proxy statement, in tabular format to the extent practicable (if a solicitation is made on behalf of persons other than the issuer, the information need be furnished only as to nominees of the persons making the solicitation):

- With respect to directors, executive officers, persons nominated to become directors or executive officers, and certain significant employees of the issuer: (a) their names and ages, (b) any family relationships between such persons, (c) information about their prior business experience (including positions held within the issuer), (d) information with respect to any agreements or understandings with any other person (identified by name) pursuant to which the person was selected to be a director or executive officer, and (e) information with regard to certain legal proceedings during the past ten years material to an evaluation of the ability or integrity of such persons (this information should also be provided with respect to promoters and control persons if the issuer has been a reporting company for less than twelve months);
- With respect to directors and director nominees: (a) a brief discussion of the specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director in light of the issuer's business and structure, and (b) other public company directorships held or held during the last five years;

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- A description of any material legal proceedings to which any director, officer or affiliate of the issuer, any owner of record or beneficially of more than 5% of any class of voting securities of the issuer, or any associate of any such director, officer, affiliate of the issuer, or stockholder is a party adverse to the issuer or any of its subsidiaries or has a material interest adverse to the issuer or any of its subsidiaries;

- A description of any transaction with the issuer since the beginning of the issuer's last fiscal year, or currently proposed, in which the amount involved exceeds $120,000 and any "related person" had or will have a direct or indirect material interest;

- A description of the issuer's policies and procedures for the review, approval, or ratification of any transaction required to be reported under clause (iv) above,

- Under the caption "Section 16(a) Beneficial Ownership Reporting Compliance," the identity of each person who, at any time during the last fiscal year, was a director, officer, beneficial owner of more than 10% of any registered class of equity securities, or any other person subject to Section 16 of the 1934 Act that failed to file on a timely basis, a report required by Section 16(a) of the 1934 Act during the most recent fiscal year or prior fiscal years, setting forth the number of late reports, the number of transactions that were not reported on a timely basis, and any known failure to file a required form;

- The identity of each director and director nominee that is independent under the independence standards applicable to the issuer;

- Information with respect to attendance by directors at board and committee meetings;

- Information with respect to the existence and composition of the issuer's audit, compensation and nominating committees, if any, including (a) the functions performed by each committee, (b) the names of each committee member and whether each such member is independent, (c) whether the committee has a charter available on the issuer's web site, and (d) the number of committee meetings held during the last fiscal year;

- With respect to the audit committee:

  - if the board of directors determines to appoint a non-independent director to the audit committee (including as a result of exceptional or limited circumstances), the nature of the relationship that makes the director non-independent and the reasons for the board's determination;

  - an audit committee report stating whether the audit committee has:

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  - — reviewed and discussed the audited financials with management;
  - — discussed with the accountants the matters required to be discussed by SAS 61, as adopted by the PCAOB in Rule 3200T;
  - — received the letter from the accountants required by applicable requirements of the PCAOB regarding their communications with the audit committee concerning independence, and has had discussions with the accountants regarding their independence; and
  - — recommended to the board of directors that the audited financials be included in the issuer's Form 10-K;

- o for issuers listed on an exchange, whether or not the issuer has a separately designated standing audit committee established in accordance with the 1934 Act or a committee performing similar functions and, if applicable, the identity of each committee member or, alternatively, a statement that the entire board of directors acts as the issuer's audit committee;
- o whether or not the issuer has at least one audit committee financial expert serving on its audit committee (identifying such director by name and stating whether such director is independent); and, if not, an explanation of why it does not have an audit committee financial expert; and
- o if applicable, disclosure of reliance on an exemption from the requirement that an audit committee by fully independent and an assessment of whether and, if so, how, such reliance would materially adversely affect the ability of the audit committee to act independently;

- With respect to the compensation committee:
  - o if the issuer does not have such a committee, the basis for the board's view that such committee is not necessary and the identity of each director who considers executive officer and director compensation;
  - o the compensation committee's processes and procedures for determining executive compensation, including:
    - — the scope and authority of the compensation committee (or other committee performing equivalent functions);
    - — the extent to which the compensation committee may delegate any authority, specifying what authority may be delegated and to whom;
    - — any role of executive officers in determining or recommending the amount or form of executive and director compensation; and

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— any role of compensation consultants in determining or recommending the amount or form of executive and director compensation;

- o the aggregate fees paid to any compensation consultant used by the compensation committee to provide advice and recommendations on executive and director compensation, if more than $120,000 in fees were paid to such consultant or its affiliates during the last completed fiscal year for additional services other than consulting on executive and director compensation; and whether the decision to engage the compensation consultant or its affiliates for these additional services was made or recommended by management and whether the compensation committee of the entire board approved such services; and

- o if any conflict of interest was raised by a compensation consultant's work, the nature of the conflict and how it is being addressed;

- With respect to the nominating committee:

  - o if the issuer does not have such a committee, the basis for the board's view that such committee is not necessary and the identity of each director who considers director nominees;

  - o if the issuer has a policy concerning stockholder nominees for director, the material terms of such policy and the procedures for stockholders who wish to nominate a director or, alternatively, the basis for the board's view that such policy is not necessary;

  - o any specific qualities or skills that the nominating committee believes are necessary for directors to possess;

  - o the process for identifying and evaluating director nominees, and any differences in procedures with respect to stockholder nominees, including any minimum qualifications for serving on the board and how the nominating committee considers diversity in evaluating nominees (if a diversity policy exists, a description of the implementation of the policy and an assessment of its effectiveness);

  - o the source of the nomination of each director nominee (other than current directors or executive officers);

  - o any fees paid to, and the function performed by, any third-party search firm that assists in identifying or evaluating potential director nominees; and

  - o whether the nominating committee received a nomination from a stockholder (or group) holding in the aggregate 5% or more of the issuer's outstanding stock;

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- Whether or not the issuer's board of directors provides a process for stockholders to send communications to the board of directors and, if the issuer does not have such a process for stockholders to send communications to the board of directors, state the basis for the view of the board of directors that it is appropriate for the issuer not to have such a process; and

- With respect to the board's leadership structure and role in risk oversight:

  - whether the same person serves as the issuer's principal executive officer and chairman of the board of directors, and, if so, whether and why the issuer has a lead independent director and the specific role that director plays in the leadership of the board;

  - the reasons why the issuer believes its leadership structure is appropriate given the specific characteristics or circumstances of the issuer; and

  - the extent of the board's role in risk oversight, such as how the board administers its oversight function, and the effect that such role has on the board's leadership structure.

Item 8. Compensation of Directors and Executive Officers.

If action is to be taken with regard to: (a) the election of directors, (b) any bonus, profit sharing, pension or retirement or other compensation plan, contract or arrangement in which any director, director nominee, or executive officer of the issuer will participate, or (c) the granting or extension to any such person of any options, warrants or rights to purchase any securities, other than warrants or rights issued to stockholders as such, on a pro rata basis, the proxy statement must include:

- A section entitled "Compensation Discussion and Analysis" which discusses the compensation awarded to, earned by, or paid to the issuer's named executive officers and explains all material elements of such compensation, including the following:

  - the objectives of the issuer's compensation programs;

  - what the compensation program is designed to reward;

  - each element of compensation;

  - why the issuer chooses to pay each element;

  - how the issuer determines the amount (and, where applicable, the formula) for each element;

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  - how each compensation element and the issuer's decisions regarding that element fit into the issuer's overall compensation objectives and affect decisions regarding other elements; and
  - whether and, if so, how the issuer has considered the results of the most recent say-on-pay vote (see Item 24 below) in determining compensation policies and decisions and, if so, how that consideration has affected the issuer's executive compensation decisions and policies.

- Complex and highly detailed quantitative information about executive compensation in tabular format required by Item 402 of Regulation S-K, including the following tables, and narrative descriptions of any material factors necessary to an understanding of the information disclosed in such tables:
  - Summary Compensation Table
  - Grants of Plan-Based Awards Table
  - Outstanding Equity Awards at Fiscal Year-End Table
  - Option Exercises and Stock Vested Table
  - Pension Benefits Table
  - Nonqualified Deferred Compensation Table
  - Director Compensation Table
  - Golden Parachute Compensation Table

- A narrative description of any termination or severance provisions or agreements applicable to the issuer's named executive officers, including a description of (a) specific circumstances that would trigger payments or benefits (including perks and health care benefits), (b) estimated payments or benefits, including the duration and by whom they would be provided, (c) how payment and benefit levels are determined under various circumstances, (d) any material conditions or obligations to the receipt of payments or benefits (*e.g.*, non-competes) and (e) any other material factors regarding such agreements.

- To the extent that risks arising from the issuer's compensation policies and practices are reasonably likely to have a material adverse effect on the issuer, disclosure of the issuer's policies and practices of compensating its employees (including non-executive officers) as they relate to risk management practices and risk-taking incentives.

- A section entitled "Compensation Committee Interlocks and Insider Participation" which (a) identifies each person who served on the issuer's compensation

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committee (or other committee performing equivalent functions) during the last completed fiscal year who (1) was an officer or employee of the issuer during the fiscal year, (2) was formerly an officer of the issuer, or (3) had any relationship during the last fiscal year requiring "related person" disclosure pursuant to Item 404 of Regulation S-K, describing such relationship; and (b) provides a description of the interlocking relationship, if during the last completed fiscal year, an executive officer of the issuer served as a member of the compensation committee (or other committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) or a director of another entity, one of whose executive officers served as a member of the issuer's compensation committee (or other committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) or as a director of the issuer.

- A section entitled "Compensation Committee Report" which (a) states whether the compensation committee (or other committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) has reviewed and discussed the CD&A with management and whether, based on such review and discussions, has recommended to the board of directors that the CD&A be included in the proxy statement; and (b) lists the names of each compensation committee member below such report.

"Smaller reporting companies" (defined, in general, as companies with a public float of less than $75 million) and "emerging growth companies" (defined, in general, as companies with total annual gross revenues of less than $1 billion during the most recent fiscal year that remain emerging growth companies and elect to be treated as such) are entitled to comply with less burdensome executive compensation disclosure requirements set forth in Item 402(m) through (r) of Regulation S-K, rather than Item 402(a) through (k) and (s). The "named executive officers" of a smaller reporting company and emerging growth company refer to the principal executive officer and the issuer's next two most highly compensated executive officers who were serving in that capacity at the end of the most recent fiscal year.

Item 9. Independent Public Accountants.

If the solicitation is made on behalf of the issuer and relates to: (1) the election of directors or (2) the approval or ratification of the issuer's accountant, the proxy statement must include (a) the name of the principal accountant being selected or recommended to stockholders for approval or ratification for the current year and (b) the name of the principal accountant for the fiscal year most recently completed if different from the accountant selected or recommended for the current year. The proxy statement also must state (1) whether or not representatives of the principal accountant for the current year and for the most recently completed fiscal year are expected to be present at the stockholders' meeting, (2) whether or not they will have the opportunity to make a statement if they desire to do so, and (3) whether or not they are expected to be available to answer questions.

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If during the issuer's two most recent fiscal years or any subsequent interim period, (1) an independent accountant who was previously engaged as the principal accountant to audit the issuer's financial statements, or an independent accountant on whom the principal accountant expressed reliance in its report regarding a significant subsidiary, has resigned (or indicated it has declined to stand for re-election after the completion of the current audit) or was dismissed, or (2) a new independent accountant has been engaged as either the principal accountant to audit the issuer's financial statements or as an independent accountant on whom the principal accountant has expressed or is expected to express reliance in its report regarding a significant subsidiary, then, notwithstanding any previous disclosure, the proxy statement must include the following information:

- Whether the former accountant resigned, declined to stand for re-election or was dismissed and the date thereof,

- Whether the principal accountant's report on the financial statements for either of the past two years contained an adverse opinion or a disclaimer of opinion, or was qualified or modified as to uncertainty, audit scope, or accounting principles, and a description of the nature of such adverse opinion, disclaimer of opinion, qualification or modification, and

- Whether the decision to change accountants was recommended or approved by the audit or similar committee of the board of directors or, if the issuer has no such committee, the full board of directors.

The proxy statement also must disclose:

- Under the caption "Audit Fees," the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the issuer's annual financial statements and review of financial statements included in the issuer's Form 10-Q or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years,

- Under the caption "Audit-Related Fees," the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the issuer's financial statements,

- Under the caption "Tax Fees," the aggregate fees billed in each of the last two fiscal years for professional services rendered by the principal accountant for tax compliance, tax advice, and tax planning, and

- Under the caption "All Other Fees," the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported in the other three categories of accountant fees.

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Issuers must describe the nature of the services comprising the fees disclosed under the "Tax Fees" and "All Other Fees" categories. The proxy statement is also required to describe the audit committee's pre-approval policies and procedures with respect to accounting services and the percentage of services other than "Audit Fees" that were approved by the audit committee pursuant to the "*de minimis*" exception in Rule 2-01(c)(7)(i)(C)(1) of Regulation S-X. Finally, if greater than 50% of the audit work for the most recent fiscal year was performed by persons other than the accountant's full-time employees, the proxy statement must disclose the percentage of work performed by such persons.

Item 10. Compensation Plans.

If action is to be taken with respect to any plan pursuant to which cash or noncash compensation may be paid or distributed, the proxy statement must include the following information:

- With respect to plans subject to stockholder action:
    - A brief description of the material features of the plan being acted upon, identifying each class of persons who will be eligible to participate therein, indicating the approximate number of persons in each such class and stating the basis of such participation;
    - In tabular format disclosure of the benefits or amounts, if such benefits or amounts are determinable, that will be received by or allocated to (1) the issuer's named executive officers, (2) all current executive officers as a group, (3) all current directors who are not executive officers as a group, and (4) all employees, including all current officers who are not executive officers, as a group; and
    - With respect to any pension or retirement plan submitted for stockholder action, the approximate total amount necessary to fund the plan with respect to past services, the period over which such amount is to be paid and the estimated annual payments necessary to pay the total amount over such period; and the estimated annual payment to be made with respect to current services.
- With respect to any specific grant of or any plan containing options, warrants or rights submitted for stockholder action:
    - (1) The title and amount of securities underlying such options, warrants or rights, (2) the prices, expiration dates and other material conditions upon which the options, warrants or rights may be exercised, (3) the consideration received or to be received by the issuer or subsidiary for the granting or extension of the options, warrants or rights, (4) the market value of the securities underlying the options, warrants, or rights as of the latest practicable

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date, and (5) in the case of options, the federal income tax consequences of the issuance and exercise of such options to the recipient and the issuer; and

  - A separate statement as to the amount of such options received or to be received by the following persons if such benefits or amounts are determinable: (1) the issuer's named executive officers, (2) all current executive officers as a group, (3) all current directors who are not executive officers as a group, (4) each director nominee, (5) each associate of any of such directors, executive officers or nominees, (6) each other person who received or is to receive 5% of such options, warrants or rights, and (7) all employees, including all current officers who are not executive officers, as a group.

- With respect to plans not subject to stockholder action:

  - In tabular format the following information as of the end of the most recently completed fiscal year with respect to compensation plans under which equity securities of the issuer are authorized for issuance, aggregated by all compensation plans (1) previously approved by stockholders and (2) not previously approved by stockholders:

    - The number of securities to be issued upon the exercise of outstanding options, warrants and rights,

    - the weighted-average exercise price of such outstanding options, warrants and rights, and

    - other than securities to be issued upon the exercise of such outstanding options, warrants and rights, the number of securities remaining available for future issuance under the plan.

Any written plan to be acted upon must be filed as an appendix to the proxy statement in the SEC filing but need not be included in the printed version sent to stockholders.

Item 11. Authorization or Issuance of Securities Otherwise Than for Exchange.

If action is to be taken with respect to the authorization or issuance of any securities otherwise than for exchange for outstanding securities of the issuer, the proxy statement must include the following information:

- The title and amount of securities to be authorized or issued.

- A detailed description of the terms of the securities to be authorized, including the following information:

  - In the case of equity securities:

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- a brief outline of (i) dividend rights; (ii) terms of conversion; (iii) sinking fund provisions; (iv) redemption provisions; (v) voting rights, including any provisions specifying the vote required by stockholders to take action; (vi) any classification of the board of directors, and the impact of such classification where cumulative voting is permitted or required; (vii) liquidation rights; (viii) preemptive rights; and (ix) liability to further calls or to assessment by the issuer and for liabilities of the issuer imposed on its stockholders under state statutes; (x) any restriction on alienability of the securities to be registered; and (xi) any provision discriminating against any existing or prospective holder of such securities as a result of such stockholder owning a substantial amount of securities;

- if the rights of holders of such stock may be modified otherwise than by a vote of a majority or more of the shares outstanding, voting as a class, a brief explanation;

- if preferred stock is to be registered, a brief description of any restriction on the repurchase or redemption of shares by the issuer while there is any arrearage in the payment of dividends or sinking fund installments or a statement that there is no such restriction;

- if the rights evidenced by, or amounts payable with respect to, the shares to be registered are, or may be, materially limited or qualified by the rights of any other authorized class of securities, information regarding such other securities as will enable investors to understand such limitations or qualifications; and

- a description of any provision of the issuer's charter or bylaws that would have an effect of delaying, deferring or preventing a change in control of the issuer and that would operate only with respect to an extraordinary corporate transaction involving the issuer (or any of its subsidiaries), such as a merger, reorganization, tender offer, sale or transfer of substantially all of its assets, or liquidation.

o In the case of debt securities:

- the title of such securities, the principal amount being offered, and, if a series, the total amount authorized and the total amount outstanding as of the most recent practicable date;

- provisions with respect to maturity, interest, conversion, redemption, amortization, sinking fund, or retirement;

- provisions with respect to the kind and priority of any lien securing the securities, together with a brief identification of the principal properties subject to such lien;

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— provisions with respect to the subordination of the rights of holders of the securities to other security holders or creditors of the issuer; including the aggregate amount of outstanding indebtedness as of the most recent practicable date that by the terms of such debt securities would be senior to such subordinated debt and any limitation on the issuance of such additional senior indebtedness or a statement that there is no such limitation;

— provisions restricting the declaration of dividends or requiring the maintenance of any asset ratio or the creation or maintenance of reserves;

— provisions restricting the incurrence of additional debt or the issuance of additional securities; in the case of secured debt, whether the securities being registered are to be issued on the basis of unbonded bondable property, the deposit of cash or otherwise; as of the most recent practicable date, the approximate amount of unbonded bondable property available as a basis for the issuance of bonds; provisions permitting the withdrawal of cash deposited as a basis for the issuance of bonds; and provisions permitting the release or substitution of assets securing the issue;

— the general type of event that constitutes a default and whether or not any periodic evidence is required to be furnished as to the absence of default or as to compliance with the terms of the indenture;

— provisions relating to modification of the terms of the security or the rights of security holders;

— if the rights evidenced by the securities to be registered are, or may be, materially limited or qualified by the rights of any other authorized class of securities, the information regarding such other securities as will enable investors to understand the rights evidenced by the securities;

— if debt securities are to be offered at a price such that they will be deemed to be offered at an "original issue discount," the tax effects thereof; and

— the name of the trustee(s) and the nature of any material relationship with the issuer or with any of its affiliates; the percentage of securities of the class necessary to require the trustee to take action; and what indemnification the trustee may require before proceeding to enforce the lien.

- A brief description of the transaction in which the securities are to be issued including a statement as to the nature and approximate amount of consideration to be received by the issuer and the approximate amount devoted to each purpose so far as determinable for which the net proceeds have been or are to be used.

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- The reasons for the proposed authorization or issuance and the general effect thereof upon the rights of existing security holders if the securities are to be issued otherwise than in a general public offering for cash.

- The detailed financial information set forth in Item 13 below concerning the issuer (generally, this financial information may be incorporated by reference into the proxy statement).

Item 12. Modification or Exchange of Securities.

If action is to be taken with respect to the modification of any class of securities of the issuer, or the issuance or authorization for issuance of securities of the issuer in exchange for outstanding securities of the issuer, the proxy statement must include the following information:

- If outstanding securities are to be modified, the title and amount thereof. If securities are to be issued in exchange for outstanding securities, the title and amount of securities to be so issued, the title and amount of outstanding securities to be exchanged therefor and the basis of the exchange;

- A description of any material differences between the outstanding securities and the modified or new securities in respect of any of the matters concerning which information would be required in the detailed description of the terms of the securities in Item 11 above;

- The reasons for the proposed modification or exchange, and the general effect thereof upon the rights of existing security holders;

- A brief statement as to arrears in dividends or as to defaults in principal or interest in respect to the outstanding securities which are to be modified or exchanged and such other information as may be appropriate in the particular case to adequately disclose the nature and effect of the proposed action;

- A brief outline of any other material features of the proposed modification or exchange; and

- The detailed financial information set forth in Item 13 below concerning the issuer.

Item 13. Financial and Other Information.

If action is to be taken with respect to any matter specified in Item 11 or 12 above, the proxy statement must include the following information:

- Financial statements meeting the requirements of Regulation S-X;

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- Supplementary financial information, as required by Item 302 of Regulation S-K;
- Management's discussion and analysis of financial condition and results of operations, as required by Item 303 of Regulation S-K;
- Changes in and disagreements with accountants on accounting and financial disclosure, as required by Item 304 of Regulation S-K;
- Quantitative and qualitative disclosures about market risk, as required by Item 305 of Regulation S-K; and
- A statement as to whether or not representatives of the principal accountants for the current year and for the most recently completed fiscal year:
    - Are expected to be present at the stockholders' meeting;
    - Will have the opportunity to make a statement if they desire to do so; and
    - Are expected to be available to respond to appropriate questions.

Item 14. Mergers, Consolidations, Acquisitions and Similar Matters.

If action is to be taken with respect to (1) a merger or consolidation, (2) an acquisition of securities of another person, (3) an acquisition of any other going business or the assets of a going business, (4) a sale or other transfer of all or any substantial part of the issuer's assets, or (5) a liquidation or dissolution, the proxy statement must include the following information for each of the parties to the transaction unless otherwise specified:

- A summary term sheet briefly describing in bullet point format the most material terms of the proposed transaction;
- The name, mailing address and telephone number of the principal executive offices;
- A brief description of the general nature of the business conducted;
- A brief description of the transaction, including the consideration offered to stockholders; the reasons for engaging in the transaction; the vote required for approval of the transaction; an explanation of any material differences in the rights of stockholders as a result of the transaction, if material; a brief statement as to the accounting treatment of the transaction, if material; and the federal income tax consequences of the transaction, if material;
- A statement as to whether any federal or state regulatory requirements must be complied with or approval must be obtained in connection with the transaction and, if so, the status of the compliance or approval;

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- If a report, opinion or appraisal materially relating to the transaction has been received from an outside party, and is referred to in the proxy statement: (a) the identity of the outside party and/or unaffiliated representative, (b) the qualifications of the outside party and/or unaffiliated representative, (c) the method of selection of the outside party and/or unaffiliated representative, (d) any material relationship that existed during the past two years or is mutually understood to be contemplated and any compensation received or to be received as a result of the relationship between (x) the outside party, its affiliates, and/or unaffiliated representative; and (y) the subject company or its affiliates, (e) if the report, opinion or appraisal relates to the fairness of the consideration, a statement as to whether the subject company or affiliate determined the amount of consideration to be paid or whether the outside party recommended the amount of consideration to be paid, and (f) a summary concerning the report, opinion or appraisal;

- During the periods for which financial statements are presented or incorporated by reference under this Item:

  - a description of any negotiations, transactions or material contacts during the past two years between the filing person and certain affiliates, including subsidiaries, and the subject company or its affiliates concerning any: merger, consolidation, acquisition, tender offer for or other acquisition of any class of the subject company's securities, election of the subject company's directors, or sale or other transfer of a material amount of assets of the subject company; and

  - if material to a stockholder's decision whether to sell, tender or hold the securities sought in the tender offer, a description of any present or proposed material agreement, arrangement, understanding or relationship between the offeror or any of its executive officers, directors, controlling persons or subsidiaries and the subject company or any of its executive officers, directors, controlling persons or subsidiaries;

- For each of the last five fiscal years, financial information including, but not limited to: (a) net sales or operating revenues, (b) income or loss from continuing operations (as well as per share data), (c) total assets, (d) long-term obligations and redeemable preferred stock, and (e) cash dividends per share; and a discussion of any factors that materially affect the comparability of the issuer's financial information reflected in the selected financial data, such as accounting changes, business combinations or dispositions of business operations;

- If material, the information required by Item 301 of Regulation S-K for the acquiring company, showing the pro forma effect of the transaction;

- In a table designed to facilitate comparison, historical and pro forma per share data of the acquiring company and historical and equivalent pro forma per share

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data of the target company for the following items: (a) book value per share, (b) cash dividends declared per share, and (c) income (loss) per share from continuing operations; and

- If material, pro forma financial information with respect to certain significant transactions.

Item 14 also requires disclosure of specified information about the parties to the transaction unless such information has been incorporated by reference into the proxy statement.

Item 15. Acquisition or Disposition of Property.

If action is to be taken with respect to the acquisition or disposition of any property, the proxy statement must include the following information:

- A brief description of the general character and location of the property;

- The nature and amount of consideration to be paid or received by the issuer or any subsidiary, and to the extent practicable, the facts bearing upon the question of the fairness of the consideration;

- The name and address of the transferor or transferee, as the case may be, and the nature of any material relationship of such person to the issuer or any affiliate of the issuer; and

- Any other material features of the contract or transaction.

Item 16. Restatement of Accounts.

If action is to be taken with respect to the restatement of any asset, capital, or surplus account of the issuer, the proxy statement must include the following information:

- The nature of the restatement and the date as of which it is to be effective;

- The reasons for the restatement and for the selection of the particular effective date;

- The name and amount of each account (including any reserve accounts) affected by the restatement and the effect of the restatement thereon (presented in tabular format where appropriate); and

- To the extent practicable, whether and the extent, if any, to which, the restatement will, as of the date thereof, alter the amount available for distribution to stockholders.

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Item 17. Action with Respect to Reports.

If action is to be taken with respect to any report of the issuer or of its directors, officers or committees or any minutes of a meeting of its stockholders, the proxy statement must include the following information:

- Whether or not such action is to constitute approval or disapproval of any of the matters referred to in such reports or minutes; and

- The identity of each of such matters which it is intended will be approved or disapproved, and the information required by the appropriate item(s) of Schedule 14A with respect to each such matter.

Item 18. Matters Not Required to be Submitted.

If action is to be taken with respect to any matter which is not required to be submitted to a vote of stockholders, the proxy statement must state the nature of such matter, the reasons for submitting it to a vote of stockholders and what action is intended to be taken by the issuer in the event of a negative vote on the matter by the stockholders.

Item 19. Amendment of Charter, Bylaws or Other Documents.

If action is to be taken with respect to any amendment of the issuer's charter, bylaws or other documents as to which information is not otherwise required by Schedule 14A, the proxy statement must include a brief description of the reasons for the amendment and its general effect.

Item 20. Other Proposed Action.

If action is to be taken on any matter not specifically referred to in Schedule 14A, the proxy statement must include a brief description of the substance of each such matter in substantially the same degree of detail as is required by Items 5 through 19 of Schedule 14A.

Item 21. Voting Procedures.

As to each matter which is to be submitted to a vote of stockholders, the proxy statement must include the following information:

- The vote required for approval or election, other than for the approval of auditors; and

- The method by which votes will be counted, including the treatment and effect of abstentions and broker non-votes under applicable state law as well as the issuer's charter and by-law provisions.

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Item 22. Information Required in Investment Company Proxy Statement.

Investment company proxy statements are very different from those of non-investment companies, and are not covered by this chapter.

Item 23. Delivery of Documents to Security Holders Sharing an Address.

If one annual report to security holders, proxy statement, or Notice of Internet Availability of Proxy Materials is being delivered to two or more stockholders who share an address, the proxy statement must:

- State that only one annual report, proxy statement, or notice, as applicable, is being delivered to multiple stockholders sharing an address unless the issuer has received contrary instructions from one or more of the stockholders;

- Undertake to deliver promptly upon written or oral request a separate copy of the annual report, proxy statement, or notice, as applicable, to a stockholder at a shared address to which a single copy of the documents was delivered and provide instructions as to how a stockholder can notify the issuer that the stockholder wishes to receive a separate copy of an annual report, proxy statement, or notice, as applicable;

- Provide the telephone number and mailing address to which a stockholder can direct a notification to the issuer that the stockholder wishes to receive a separate annual report, proxy statement, or notice, as applicable, in the future; and

- Instruct stockholders sharing an address how to request delivery of a single copy of annual reports, proxy statements, or notices if they are receiving multiple copies of such documents.

Item 24. Shareholder Approval of Executive Compensation.

The Dodd-Frank Act added Section 14A to the 1934 Act requiring public companies subject to the proxy rules to include, at least once every three years, a separate non-binding vote (the "say-on-pay vote") in their proxy statements by which stockholders may approve the compensation of named executive officers as disclosed in the proxy statement pursuant to Item 402 of Regulation S-K (See Item 8 above). Public companies must also hold a separate non-binding vote (the "say-on-frequency vote") at least once every six years regarding whether the company should hold a say-on-pay vote every one, two or three years. Finally, Section 14A(b) of the 1934 Act requires a company to give stockholders a non-binding vote (the "say-on-golden parachute vote") to approve certain disclosed "golden parachute" compensation arrangements in the event of a merger or other extraordinary transaction unless such arrangements were previously subject to a say-on-pay vote, in which case no additional vote would be required.

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If an issuer is required by Rule 14a-21 under the 1934 Act to provide a separate say-on-pay vote, say-on-frequency vote or say-on-golden parachute vote, the proxy statement must include the following information:

- disclosure that the issuer is providing any such vote as required by Section 14A of the 1934 Act;
- a brief explanation of the general effect of each vote, such as whether it is non-binding; and
- when applicable, disclosure of the current frequency of say-on-pay votes and when the next say-on-pay vote will occur.

Smaller reporting companies are subject to the say-on-pay and say-on-frequency vote requirements beginning with the first annual meeting held on or after January 21, 2013. Emerging growth companies are not required to hold say-on-pay, say-on-frequency or say-on-golden parachute votes while they retain such status.

Pending Proxy Statement Disclosure Requirements

The Dodd-Frank Act directs the SEC to adopt rules which will require issuers to provide additional compensation disclosure in their proxy statements. Section 953 of the Dodd-Frank Act added new Section 14(i) to the 1934 Act, which directs the SEC to require issuers (other than EGCs) to provide "pay-for-performance" disclosure, which may be in the form of a graph, showing the relationship between executive compensation actually paid and the issuer's financial performance, taking into account any change in the value of its stock and dividends. Section 953 also directs the SEC to amend Item 402 of Regulation S-K to require issuers (other than EGCs) to disclose in their proxy statements:

- The median of annual total compensation of all employees other than the CEO;
- The annual total compensation of the CEO; and
- The ratio of the median employee annual total compensation to the CEO's annual total compensation.

Annual total compensation is to be calculated in the same manner as it is calculated for purposes of the summary compensation table.

Section 954 of the Dodd-Frank Act adds a new Section 10D to the 1934 Act regarding compensation clawbacks. Section 10D requires listed companies to adopt a policy that provides for the recoupment of three years' worth of incentive-based compensation paid to current and former executive officers if an accounting restatement is required due to material noncompliance with any financial reporting requirements. Section 10D(b)(1) directs the SEC to adopt rules requiring each issuer to disclose its policy on incentive-based compensation granted on the basis of publicly reported financial information.

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Section 955 of the Dodd-Frank Act added new Section 14(j) to the 1934 Act, which directs the SEC to require issuers to disclose in their proxy statement whether any of their employees or directors are permitted to purchase financial instruments designed to hedge against losses on the issuer's stock (x) granted to such person as part of compensation or (y) otherwise held directly or indirectly by such person.

To date, the SEC has not yet proposed rules regarding disclosure of pay-for-performance, pay ratios, hedging by employees and directors or clawback policies. Some issuers have voluntarily disclosed information about pay-for-performance and hedging restrictions in their CD&As in advance of the proposed rules where they believe such information may be helpful in persuading stockholders to vote in favor of the say-on-pay proposal. In anticipation of the new rules, issuers would be well-advised to begin considering how best to gather the new compensation data that will be required to be disclosed.

DISCLOSURE REGARDING NON-GAAP FINANCIAL MEASURES[138]

A "non-GAAP financial measure" is a financial measure that is a numerical measure of the issuer's historical or future financial performance, financial position or cash flow that excludes amounts that are included, or includes amounts that are excluded, from the most directly comparable GAAP financial measure. Common examples of non-GAAP financial measures include EBIT, EBITDA, core earnings, funds from operations, adjusted revenues and adjusted earnings. The definition of "non-GAAP financial measure" does not include financial measures specifically required by GAAP, SEC rules or other applicable regulations and common examples of numerical measures that fall outside the scope of the definition include operating and statistical measures (such as unit sales, number of customers or number of customer contracts), disclosures of expected or contracted indebtedness, financial measures required by the issuer's regulator (such as capital adequacy ratios disclosed by banks) and measures which are calculated using GAAP figures (such as GAAP revenue per square foot). Care should be taken in determining what non-GAAP measures are used, because this disclosure often receives careful scrutiny from investors, analysts and the SEC.

The use of non-GAAP financial measures is governed by Regulation G and Item 10(e) of Regulation S-K (which were adopted pursuant to Sarbanes-Oxley Section 401(b)). Regulation G applies to all public disclosure by any issuer that is required to file reports under Section 13(a) or 15(d) of the 1934 Act. Item 10(e) of Regulation S-K contains requirements that are stricter than those of Regulation G, but only applies to filings made with the SEC.

Under Regulation G, any oral or written public disclosures (such as press releases, information posted to the issuer's web site, conference calls with analysts or investors, and

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[138] See Sarbanes-Oxley Section 401(b); Regulation G; Regulation S-K Item 10(e); Form 20-F Gen'l Inst. C.(e).

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all public filings with the SEC) that are made by the issuer or anyone acting on its behalf and that contain non-GAAP financial measures must also include:

- the most directly comparable GAAP financial measure; and
- a quantitative reconciliation to GAAP of each non-GAAP financial measure.[139]

In practice, an issuer that discloses non-GAAP financial measures in a written earnings or other press release would typically comply with Regulation G by including the comparable GAAP information and reconciliation in the same release. However, if the non-GAAP financial measure is disclosed orally, telephonically, by webcast or broadcast or similar means, the issuer can comply with Regulation G by (1) posting the required comparable GAAP measures and reconciliation on its web site at or before the same time that it discloses the non-GAAP financial measures and (2) during the presentation stating that this information can be found on the issuer's web site and providing the address of that web site.

Item 10(e) of Regulation S-K imposes a stricter version of these requirements, and additional requirements, on the use of non-GAAP financial measures in any SEC filing (including all periodic reports under the 1934 Act and registration statements under the 1933 Act). Under Item 10(e), if an issuer includes a non-GAAP financial measure in an SEC filing, it must also include:

- the most directly comparable GAAP financial measure, which must be given equal or greater prominence as the non-GAAP financial measure;
- a quantitative reconciliation of each non-GAAP financial measure to the most directly comparable GAAP financial measure; and
- a statement disclosing (i) the substantive reasons why management believes that the non-GAAP financial measures may be useful to investors and (ii) any material other purposes for which management uses the non-GAAP financial measures.[140]

In addition, Item 10(e) of Regulation S-K prohibits the following in all SEC filings:

- excluding charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP liquidity measures, other than the measures EBIT and EBITDA;

[139] With regard to forward-looking information, a quantitative reconciliation is only required to the extent available without unreasonable efforts. In such cases, the issuer must identify the information that is unavailable and disclose its probable significance.

[140] The information in this bullet is not required if the SEC filing is not a Form 10-K or Form 20-F and the company's last Form 10-K or Form 20-F (or other more recent SEC filing) contained an up-to-date version of the required information.

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- adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when (1) the nature of the charge or gain is such that it is reasonably likely to recur within two years, or (2) there was a similar charge or gain within the prior two years;

- presenting non-GAAP financial measures on the face of an issuer's financial statements prepared in accordance with GAAP or in the accompanying notes;

- presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; and

- using titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.

In 2010, subsequent to the adoption of Regulation G and Item 10(e) of Regulation S-K, the SEC issued a series of compliance and disclosure interpretations[141] that liberalized the use of non-GAAP financial measures with the intent of promoting consistency between an issuer's public disclosures to analysts and investors and its annual and current reports filed with the SEC. This has helped lead to increased use of non-GAAP financial measures, especially since many issuers and underwriters believe that they contain information of importance to investors. The disclosure relating to non-GAAP financial measures may receive careful scrutiny from both the SEC and investors.

[141] The release is available at www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

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CHAPTER 5

SHELF REGISTRATION

GENERAL 160
SECURITIES COVERED BY RULE 415 160
SHELF REGISTRATION PROCEDURES 162
SHELF UPDATING PROCEDURES 168
DUE DILIGENCE 169

GENERAL

A 1933 Act shelf registration statement covers securities that are not to be sold in a single discrete offering immediately upon effectiveness, but rather are intended to be sold in a number of offerings over a period of time or on a continuous basis.

Shelf registrations are governed by Rule 415 under the 1933 Act. Rule 415 permits issuers to register securities in advance of their offering, placing them "on the shelf" for immediate takedown without any further review or action by the SEC, thereby dramatically reducing the time to execute an offering. Shelf registrations have resulted in standardization of basic documentation, "bought deals" and greater product flexibility to satisfy windows of issuer and investor demand. In addition, WKSIs are entitled to file automatic shelf registration statements, which become effective upon filing.[142]

Securities Offering Reform established four categories of issuers: WKSIs, seasoned issuers, unseasoned 1934 Act reporting issuers and non-reporting issuers. Two other categories of issuers—ineligible issuers and voluntary filers—also must be taken into account to determine what registration requirements and limitations apply to an issuer.

SECURITIES COVERED BY RULE 415

Rule 415 permits registration of the following on a shelf registration statement:

(i) securities to be offered or sold by selling securityholders other than the issuer, or a parent or subsidiary of the issuer (this provision permits issuers to provide shelf registration rights to securityholders that purchased their securities in a private placement or otherwise hold restricted securities);

[142] See Chapter 1 (*The Offering Process – Issuer Classes*) for a description of these categories of issuers.

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(ii) securities offered and sold by an issuer pursuant to a dividend or interest reinvestment plan or an employee benefit plan;

(iii) securities to be issued upon the exercise of outstanding options, warrants or rights;

(iv) securities which are issued upon conversion of other outstanding securities;

(v) securities pledged as collateral;

(vi) securities registered on Form F-6 (*i.e.*, ADRs);

(vii) mortgage-related securities, including such securities as mortgage-backed debt and mortgage participation or pass-through certificates;

(viii) securities to be issued in connection with business combination transactions;

(ix) securities the offering of which will be commenced promptly, will be made on a continuous basis and may continue for a period in excess of thirty days from the date of initial effectiveness (this provision provides one option for shelf registration of medium-term notes and at-the-market offerings);

(x) securities registered or qualified to be registered on Form S-3 or F-3, as the case may be, which are to be offered and sold on an immediate, continuous or delayed basis by or on behalf of an issuer, or a parent or subsidiary of the issuer (this provision provides the most flexible option for primary offerings, including offerings of medium-term notes and at-the-market offerings); and

(xi) shares of common stock which are offered and sold on a delayed or continuous basis by or on behalf of a registered closed-end management investment company or business development company that makes periodic repurchase offers under Rule 23c-3 of the 1940 Act.

Clause (x) of Rule 415 is the provision that most issuers use to register primary offerings of securities because, by allowing incorporation by reference of future 1934 Act filings, as well as prior filings, and permitting delayed offerings, Form S-3 provides the most updating and product flexibility. Issuers that are not eligible to use Form S-3 may nevertheless register shelf securities, such as medium-term notes, pursuant to clause (ix). Clause (ix) is less flexible than clause (x) inasmuch as it permits continuous offerings (such as medium-term note programs and at-the-market offerings) but not delayed offerings. However, if shelf securities are registered on Form S-1 (which permits incorporation by reference of prior 1934 Act filings after the issuer has filed an annual report required under Section 13(a) or 15(d), but no forward incorporation by reference of subsequently filed documents), a post-effective amendment must be filed with the SEC annually and a new prospectus prepared each time the issuer files its annual and periodic reports under the 1934 Act.

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SHELF REGISTRATION PROCEDURES

Automatic Shelf Registration Statements

WKSIs have the most shelf registration procedure benefits, including automatic registration statements and amendments and pay-as-you-go registration fee arrangements. Larger, more mature issuers, including both WKSIs and seasoned issuers, also benefit from procedures for shelf registration statements that permit the omission of certain information as of the effective date and remove certain limitations on the quantity of securities registered for delayed sale.

WKSIs may file "automatic shelf registration statements." This means that they are effective upon filing and not subject to pre-effective review by the staff of the SEC. Taken together with the SEC's communications rules that permit WKSIs (but not underwriters on their behalf[143]) to make offerings of securities before the filing of a registration statement, the automatic shelf registration statement rules permit WKSIs to file the registration statement and immediately commence an offering. Additional filing requirements apply at the time sales are made under the shelf. An automatic shelf registration statement may cover both primary and secondary offerings.

WKSI status is measured as of the filing date and is subject to reevaluation at the time the registration statement is updated for purposes of Section 10(a)(3) of the 1933 Act, which is the date the annual report on Form 10-K is filed. A WKSI holding the status solely on the basis of debt or preferred stock issuances would be limited to the sale of non-convertible debt or preferred securities unless its common equity securities held by unaffiliated persons had a market value of at least $75 million. Certain subsidiaries of WKSIs may be included on their parent's automatic shelf registration statements if they do not qualify for WKSI status on their own. Form S-3 is the only form of registration statement that allows U.S. issuers to use the automatic shelf technique.

Contents of Automatic Shelf Registration Statements

The automatic shelf registration statement needs to include only the information required by Rule 430B under the 1933 Act. While an automatic shelf registration statement could consist only of the facing sheet (identifying the form of registration statement, the issuer, and the types of securities included), a single-page prospectus identifying the WKSI and the types of its securities (without specifying an amount) to be sold and incorporate by reference its recent and future 1934 Act filings, a signature page and any required exhibits, most automatic shelf registration statements continue to follow the pre-Securities Offering

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[143] SEC Release No. 33-9098 proposed to amend Rule 163(c) to authorize an underwriter or dealer to act as the agent or representative of a WKSI in communicating about offerings of the WKSI's securities prior to the filing of a registration statement. The deadline to submit comments on this proposal expired on January 27, 2010, but no further action has been taken by the SEC to date.

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Reform practice and include a description of each type and class of securities expected to be offered under the shelf. This is done so as to limit the additional information that needs to be prepared and delivered to purchasers at the time of sale, as discussed in Chapter 4 (*Disclosure Requirements*).

Among the types of securities that have been included in the more complete universal registration statements are:

- Debt securities: senior and subordinated, convertible into equity securities of the issuer, exchangeable for securities of another issuer, fixed and variable interest rates and principal amount at maturity, interest and/or principal payable in various currencies, interest gross-up provisions for non-U.S. offerings, zero-coupon securities[144] and warrants to purchase debt securities.

- Equity securities: common stock, preferred stock (including depositary receipts), warrants to purchase equity securities, and warrants with a value at maturity tied to a specified securities index, currency or other benchmark.

Transactional and other disclosures otherwise required may be provided at the time of sale either through (i) a Rule 424(b) prospectus that is deemed to be a part of the registration statement, (ii) a 1934 Act filing incorporated by reference, (iii) a free writing prospectus or (iv) a post-effective amendment to the registration statement. A filing under Rule 424(b)(2), (b)(5) or (b)(7) supplying the information omitted in reliance on Rule 430B will be deemed to be a new effective date of the registration statement, a matter of significance for liability issues, including the statute of limitations.

Liability under Section 11 for information contained in a registration statement attaches at the time the portion of the registration statement containing such information becomes effective. In a typical securities offering, the timing of effectiveness can differ depending on the parties involved. Issuers and underwriters, for example, assume liability for transactional and other disclosures provided at the time of sale via a Rule 424(b) prospectus at the earlier of (i) the time such prospectus is first used or (ii) the time of the first contract for sale of securities to which the prospectus relates. Each such date in the preceding sentence is referred to as a new effective date of the registration statement.

Any seller of securities may also have liability under Section 12(a)(2) of the 1933 Act if such seller offers and sells securities by means of a prospectus or oral communication that contains an untrue statement of a material fact or omits to state a material fact and such seller does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the material misstatement or omission. This liability is based

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[144] If zero coupon securities are included, a footnote to the fee table on the cover page of the registration statement should be added to indicate that securities will be issued with significant original issue discount determined by the amount to be paid by purchasers in the public offering.

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upon the information conveyed to the purchaser at the time of sale; Rule 159 of the 1933 Act states that any information conveyed to a purchaser of securities after the time of sale will not be taken into account when determining liability under Section 12(a)(2).

Accountants or other specialists that provide an opinion or report based on their expertise in a particular field, assume liability for the contents of that opinion or report as of the date it is deemed to be a part of the registration statement. In the context of a typical shelf registration statement that incorporates by reference an issuer's 1934 Act filings, an accountant's liability for the contents of its 10-K audit report on an issuer's year-end financial statements would attach at the time such 10-K was filed with the SEC, and therefore incorporated by reference into the issuer's shelf registration statement.

Similar to the standard for accountants and other experts, to the extent an individual officer or director of an issuer may be subject to Section 11 liability for information contained or incorporated by reference in a registration statement, such liability would attach as of the date the director or officer signed the relevant disclosure document rather than at a date subsequent thereto when an offering may occur.

Fees for Automatic Shelf Registration Statements

A WKSI filing an automatic shelf registration statement has the option to pay the SEC registration fee for the entire amount of securities it expects eventually to sell under the registration statement or to pay as the securities are sold, which the SEC calls pay-as-you-go registration fees. Both methods may be used at the same time. For example, a WKSI may elect to prepay fees for some future offerings while deferring fees for others. Because registration fees for shelf offerings can be significant, the option to defer payment is attractive. For continuous offering programs, such as medium-term note facilities, issuers may want to consider use of the lock-box account offered by the SEC.[145]

When prepayments are made, the fee table in the registration statement should list each type of security being registered and either state whether a filing fee is being paid with the filing, or indicate "$0" in the filing fee table and state that the filing fee will be paid subsequently in advance or on a pay-as-you-go basis.[146] No allocation of the fee among the included classes or specification of the amount of each class proposed to be sold is required.

If a WKSI defers fees for an automatic shelf registration statement, the fee table must identify the classes of securities covered by the registration statement and note reliance on Rules 456(b) and Rule 457(r), the enabling rules for pay-as-you-go fees. Rule 456(b) specifies additional procedures for deferred fees. Deferred fees must be paid not later than the date the prospectus relating to the securities is required to be filed under Rule 424(b),

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[145] Fees paid through the use of a lock-box account will be calculated at the time the money is withdrawn from the account to make the payment, not at the time the money is deposited in the account.

[146] See Compliance and Disclosure Interpretation 240.14.

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calculated on the basis of the rates in effect as of such date. Good-faith failures to pay a fee will be deemed to have been timely if paid within four days of the original due date. At the time of the deferred payment, the issuer must update the fee table either in a Rule 424(b) prospectus supplement filing or in a post-effective amendment to the automatic shelf registration statement.

Post-Effective Amendments

Rule 413(b) specifies that a WKSI can add securities to an automatic shelf registration statement by means of a post-effective amendment, an action not available to non-WKSIs which are covered by Rule 413(a). In addition to its own securities, a WKSI may add the securities of a qualifying majority-owned subsidiary, whether or not the subsidiary had previously been a registrant under the registration statement. Such post-effective amendments will become effective on filing. A non-WKSI can use Rule 462(b) to register additional securities, but only in an amount and at a price that together represent no more than 20% of the maximum aggregate offering price set forth for each class of securities in the "Calculation of Registration Fee" table contained in the earlier registration statement. However, for a delayed shelf registration statement, Rule 462(b) can only be used once and only at the time of the final takedown and only for a dollar amount based upon the amount then remaining on the shelf prior to the final takedown.[147] Except for continuous offerings in connection with dividend reinvestment plans, Rule 462(b) may only be used to increase the number of shares registered prior to sending the confirmation for the first sale of securities in the offering.[148]

Other Shelf Registration Procedures

Registration of Unlimited Quantities of Securities

There is no limit on the amount of securities that can be registered by WKSIs and seasoned issuers. In fact, they are not required to specify any amount of securities that may be issued under the shelf registration statement. For continuous primary offerings (*i.e.*, offerings by the issuer under Rule 415(a)(1)(ix)) not registered on Form S-3, other issuers are limited to the amount of securities the issuer reasonably believes would be sold in the succeeding two years. This limitation also applies to acquisition shelf registration statements and certain continuous offerings, such as best-efforts offerings for unseasoned issuers. The expiration of the two-year period, however, will not terminate the registration of any securities that remain unsold and the registration statement may continue to be used to the extent permitted by Rule 415(a)(5).[149]

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[147] See Compliance and Disclosure Interpretation 244.03.

[148] See Compliance and Disclosure Interpretation 244.04.

[149] See Compliance and Disclosure Interpretation 212.16.

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Maximum Three-Year Life for Shelf Registration Statements

Rule 415(a)(5) provides that shelf registration statements for WKSIs, seasoned issuers, mortgage-backed securities, certain continuous offerings and delayed primary offerings are subject to a three-year limitation (*i.e.*, offerings by the issuer under Rules 415(a)(1)(vii), (ix) or (x)). In general, to be permitted to make further sales, the issuer will be required to file a new shelf registration statement on or before the third anniversary of the effective date of the older shelf registration statement. Automatic registration statements become effective on filing, so there should be no interruption in market access for WKSIs. To provide some assurance to other issuers that market access will continue in the period during which their new registration statements may be reviewed by the SEC staff, sales of securities under old shelf registration statements other than the automatic shelf registration will be permitted for an additional six months. SEC registration fees from any securities unsold under registration statements subject to the three-year rule can be applied to the new registration statements.[150]

Certain Shelf Registration Contents

Registration statements for mortgage-backed securities and for delayed primary offerings are required to include only limited disclosures at the time of filing.

At-the-Market Offerings

At-the-market offerings in any amount are possible, with or without the services of an underwriter or agent.[151] The only condition is that the issuer be eligible to make a primary offering on Form S-3 at the time the registration statement is filed or updated to satisfy Section 10(a)(3).

Immediate Offerings upon Effectiveness

Securities Offering Reform eliminated the so-called “convenience shelf” problem by amending Rule 415 to authorize an immediate takedown after effectiveness. Prior to Securities Offering Reform, the SEC staff’s position was that an immediate takedown was not permitted without the use of a pricing amendment or the procedures associated with Rule 430A.

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[150] The SEC has published guidance regarding the three-year limitation for shelf registration statements and the conditional procedure permitting sales for up to six additional months. See http://www.sec.gov/divisions/corpfin/guidance/415a5guidance6.htm.

[151] Rule 415 under the 1933 Act defines an at-the-market offering as an offering of equity securities “into an existing trading market for outstanding shares of the same class at other than a fixed price.”

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Identification of Selling Securityholders

Generally, the view of the SEC staff is that selling securityholders must be identified at the time of effectiveness of the registration statement covering a secondary offering of their securities or, if the sellers are unknown, by means of a post-effective amendment prior to sale by the previously unnamed persons. For registration statements on Form S-3, however, pursuant to Rule 430B, issuers may supply the names of selling securityholders after effectiveness in a prospectus filed under Rule 424(b), in a 1934 Act report incorporated by reference, or in a post-effective amendment. The use of the Rule 424 filing will be the recommended procedure in almost all cases. Alternatively, issuers may supply the names of selling securityholders after effectiveness if (i) the initial offering of the securities to be sold has been completed, (ii) the securities to be sold were issued and outstanding prior to the date that the registration statement covering their resale is filed, (iii) the registration statement refers to the selling securityholders in a generic manner, and (iv) neither the issuer nor any predecessor of the issuer was a blank check company, shell company or issuer of penny stock during the prior three years.

Rule 430B requires issuers ineligible to register primary offerings on Form S-3 to identify selling securityholders at the time of effectiveness of a registration statement covering a secondary offering of securities or, if the sellers are unknown, by means of a post-effective amendment prior to sale by the previously unnamed persons. Because these post-effective amendments will not be automatically effective when filed, there may be a delay in their use.

Incorporation by Reference by Unseasoned Issuers

Form S-1 permits incorporation by reference of prior 1934 Act reports by reporting companies ineligible to use Form S-3. An issuer that has been reporting under the 1934 Act for at least twelve months and that has filed its annual report on Form 10-K for its most recent fiscal year may incorporate by reference most of the business and financial information required within the prospectus from its periodic reports. The incorporation by reference is permitted only for historical reports. Unlike Form S-3, future periodic reports will not be incorporated by reference into Form S-1 as they are filed.

Documentation

The documentation required for a shelf registration varies depending upon the type of security involved. However, the process of documenting the registration, offering and sale of shelf securities is generally the same regardless of which type of security is involved.

At the time the securities are registered under a 1933 Act registration statement, the basic documents are filed with the SEC. The base prospectus, which typically permits broad variations on the securities that can be issued, is finalized at the time of effectiveness. In the case of debt or mortgage-backed securities, an open-ended indenture that permits numerous types of debt or mortgage-backed securities is qualified under the 1939 Act. In the case of trust preferred securities, a base trust declaration that contemplates various terms is qualified

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under the 1939 Act.[152] In the case of preferred stock, a form of charter amendment or board of director certificate of designation required to establish the basic terms of the preferred stock is normally included as part of the filing package. In other cases, such as registration of rights and warrants, the documents creating the rights or warrants also are normally filed with the registration statement. The form of underwriting agreement or distribution agreement is included as part of the filing package.

The documentation process for Rule 415 shelf registrations allows issuers to quickly access the U.S. capital markets. For example, when a financing opportunity arises, the issuer will already have on hand the form of registered securities and pre-negotiated underwriting arrangements and, in the case of debt securities and trust preferred securities, pre-negotiated indenture and trustee arrangements. The underwriting agreement or a brief terms agreement in the form previously filed with the SEC is signed. The terms of the new securities and the underwriting arrangements are set forth in a prospectus supplement and/or term sheet that is conveyed to investors at or prior to the time of sale, together with the base prospectus. The securities are issued pursuant to pre-established procedures with the underwriters or selling agents and, in the case of debt securities, the trustee. Although the prospectus supplements and certain related documents are filed with the SEC at the time of a "take-down" of securities "off the shelf," the SEC does not ordinarily review these filings.[153]

SHELF UPDATING PROCEDURES

In order to issue securities registered on a shelf registration statement, an issuer must keep current the information about itself that is included or incorporated by reference in the prospectus. This is required by the undertakings that the issuer must make to the SEC when it registers securities in accordance with Rule 415 and Rule 3-12 of Regulation S-X. Rule 3-12 of Regulation S-X governs the age of financial statements that issuers filing 1933 Act registration statements are required to include or incorporate by reference in any prospectus used to sell securities.[154]

Rule 415 Undertakings

Item 512(a) of Regulation S-K requires that if securities are being registered pursuant to Rule 415, the issuer must include in the 1933 Act registration statement undertakings that,

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[152] All documents required to be qualified under the 1939 Act must be filed or incorporated by reference as exhibits to the registration statement and so qualified prior to effectiveness of the registration statement or by means of a post-effective amendment.

[153] In connection with many shelf registration programs, the SEC has indicated that it will review prospectus supplements that relate to "novel or unique" securities. Therefore, in connection with such securities or other product areas that raise questions about the application of the 1933 Act, it may be prudent to consult with the SEC in advance of an offering to ensure that it has no objections prior to issuing the securities.

[154] For further information on the requirements regarding the age of financial statements and related issues, see the discussion in Chapter 4 (*Disclosure Requirements*).

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among other things, require the issuer (other than a registrant on Form S-3 or S-8) to file, during any period in which offers are being made, a post-effective amendment:[155]

(1) to include any prospectus required by Section 10(a)(3) of the 1933 Act (which provides that any prospectus used more than nine months after the effective date of a registration statement must contain information as of a date not more than sixteen months prior to its use);

(2) to reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment) that, individually or in the aggregate, represent a "fundamental change" in the information set forth therein; and

(3) to include any material information with respect to the plan of distribution not disclosed in the registration statement or any material change in such information.

In the case of registration statements on Form S-3, these undertakings are generally satisfied by including the required information in a 1934 Act report that automatically is incorporated by reference in the registration statement or in a prospectus supplement. See Item 512(a)(1)(iii)(B).

Item 512(a)(5) of Regulation S-K also requires an agreement by the issuer that information in any prospectus supplement shall be deemed part of and included in the registration statement as of the date filed, and that, as provided in Rule 430B, new effective dates as to the issuer and underwriter shall occur in respect of each prospectus related to most shelf takedowns. Item 512(a)(6) of Regulation S-K states that if certain communications are used to offer or sell securities to a purchaser, the undersigned registrant will be a seller to the purchaser and will be considered to offer or sell such securities to such purchaser.

DUE DILIGENCE

The due diligence performed by investment banks and their counsel for a 1933 Act-registered offering has adapted to the continuous or delayed offering aspects of shelf registrations. At the time an issuer registers securities on a 1933 Act shelf registration statement, interview due diligence sessions and document due diligence sessions are conducted in much the same fashion as a non-shelf registration.[156] Following shelf registration, due diligence is done on a periodic or "update" basis.

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[155] Post-effective amendments (other than post-effective amendments to automatic shelf registration statements) are subject to SEC review and, unlike prospectus supplements, must be declared effective by the SEC before the prospectus may be used in confirming sales.

[156] See Chapter 1 (*The Offering Process*) for a further discussion of due diligence.

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Updating interview and document due diligence when an issuer publishes its annual and interim financial statements is the preferred approach for issuers that want to ensure their shelf registrations are available on short notice. Generally, unless there are significant problems or developments in the issuer's business, interview and document due diligence for continuously offered securities such as medium-term notes are only updated when new financial statements are published. In between these sessions, the underwriters rely on their prior due diligence efforts and the knowledge that their banking and research personnel have about the issuer. The interview due diligence sessions are either meetings or conference calls with the underwriters and their counsel. In the case of a debt shelf that permits the issuance of securities other than medium-term notes, it is customary for the issuer to invite prospective underwriters and their counsel to the periodic update meetings and to update the due diligence by conference call prior to the time of each take down.[157]

[157] For a discussion from the underwriter's point of view of due diligence techniques in shelf takedowns and medium-term note offerings, see the Committee on Federal Regulation of Securities' report entitled Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws (48 BUS. LAW. 1185 (1993).

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CHAPTER 6

LISTING ON U.S. SECURITIES EXCHANGES

GENERAL 171
LISTING EQUITY SECURITIES ON THE NYSE AND THE NYSE ARCA 172
LISTING EQUITY SECURITIES ON THE NYSE MKT 188
LISTING EQUITY SECURITIES ON THE NASDAQ MARKETS 196
LISTING CERTAIN SECURITIES OTHER THAN EQUITY SECURITIES 206

GENERAL

Issuers may list their common equity and other types of securities, such as debt, equity-linked debt and preferred securities, on U.S. securities exchanges. We have set forth below certain considerations and procedures relevant to listing securities on the NYSE, the NYSE Arca, the NYSE MKT (formerly known as NYSE Amex)[158] and Nasdaq (which itself consists of three different markets), followed by a summary description of the requirements applicable to listing certain other types of securities on the NYSE, the NYSE Arca, the NYSE MKT and Nasdaq.

In general, the NYSE is known for its listings of large, blue-chip issuers, while the NYSE Arca increasingly attracts exchange-traded funds through its fully electronic exchange. The NYSE MKT targets small to medium-sized issuers through its comparatively less stringent listing requirements than the NYSE. The Nasdaq markets developed a reputation for attracting technology and other growth-oriented upstarts, however, the Nasdaq Global Market and Nasdaq Global Select Market are considered to have among the highest listing standards in the industry. The Nasdaq Capital Market tends to attract smaller, growth-oriented issuers with its comparatively less stringent requirements.

As a general rule, to qualify for listing on a U.S. national securities exchange, securities must be registered with the SEC under Section 12(b) of the 1934 Act. Upon approval, and following receipt of all necessary documentation, the exchange will certify its approval of the listing with the SEC. Trading can commence upon effectiveness of the issuer's 1934 Act registration statement. Registration under the 1934 Act by an issuer must be made on Form 10, unless the issuer is already filing reports under the 1934 Act or the registration is in conjunction with a 1933 Act-registered public offering, in which case Form 8-A may be used.[159]

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[158] Effective May 14, 2012, NYSE Amex was renamed NYSE MKT. NYSE MKT had indicated that its associated options market will continue to do business under the name NYSE Amex Options.

[159] These and other SEC forms are available at SEC Forms.

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Once an issuer has registered securities under the 1934 Act, it will have to comply with certain periodic reporting requirements. These requirements include, at a minimum, filing with the SEC quarterly reports on Form 10-Q, current reports on Form 8-K and annual reports on Form 10-K.[160] In addition to compliance with such periodic reporting requirements, issuers listing on U.S. exchanges and, therefore, registering with the SEC are obligated to comply with certain other obligations, such as Sarbanes-Oxley, Dodd-Frank, beneficial ownership reporting rules, the Foreign Corrupt Practices Act, Office of Foreign Assets Control requirements, proxy rules, insider trading and short swing profit rules and an obligation to report material events promptly to investors. These subjects are addressed in detail in Chapter 7 (*Ongoing Reporting and Other Requirements*).

For a chart that summarizes the listing and fee requirements of the various NYSE and Nasdaq markets, see Appendix A – (*The NYSE and Nasdaq Markets: Distribution Requirements for Equity Securities*).

LISTING EQUITY SECURITIES ON THE NYSE AND THE NYSE ARCA[161]

NYSE Euronext operates three exchanges in the United States: the NYSE, the NYSE Arca (a fully electronic exchange) and the NYSE MKT. This section discusses listing on the NYSE and the NYSE Arca. The NYSE MKT (the former American Stock Exchange, which was acquired by NYSE Euronext in 2008 and previously called the NYSE Amex) is discussed separately because it has preserved certain listing procedures from those that existed prior to its acquisition by NYSE Euronext. A discussion regarding listing on the NYSE MKT appears below under "Listing Equity Securities on the NYSE MKT."

A U.S. issuer must qualify for listing on the NYSE or the NYSE Arca under the NYSE's Domestic listing standards (the "NYSE U.S. Listing Standards").

The minimum listing standards for the NYSE Arca are lower than those applicable to the NYSE.

NYSE and NYSE Arca Process for Listing Equity Securities

The first step in the application process for listing on the NYSE is to contact the NYSE to request a confidential review of eligibility. Only after the NYSE has provided the issuer with a letter notifying it of its eligibility and conditions of listing should the issuer submit a listing application. The listing application must contain certain information in narrative form, supplemented by financial statements as required. The narrative should

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[160] See Chapter 3 (*The Securities Registration and Reporting Process*) and Chapter 7 (*Ongoing Reporting and Other Requirements*).

[161] See NYSE Listed Company Manual for a link to the NYSE Listed Company Manual; see NYSE Arca Equities Rules for a link to the NYSE Arca Rules for equities.

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provide a summary description of the issuer's business and its securities. The issuer should also include any information required as discussed below.

An issuer interested in listing on the NYSE Arca must submit a listing application and the information described below. Issuers that meet the NYSE Arca's listing standards are not automatically approved and the listing approval of a given issuer is at the sole discretion of the NYSE Arca.

In connection with the review of any listing application, each of the NYSE and the NYSE Arca reserves the right to request additional public or non-public information or documentation as it may deem necessary and appropriate to make a determination regarding the listing eligibility of the applicant, including any material provided to or received from the SEC or other appropriate regulatory authority.

Additionally, for each of the NYSE and the NYSE Arca, an issuer must also file a registration statement with the SEC on Form 10 or Form 8-A to register the securities to be listed under the 1934 Act.

NYSE and NYSE Arca Fees for Listing Equity Securities[162]

The fees payable to the NYSE or the NYSE Arca consist of an initial listing fee, an annual listing fee and fees for listing additional securities of a class of previously listed securities.

Initial Listing Fees. The NYSE divides securities into several classes,[163] and each class has a different minimum fee and fee per share. On the NYSE, the initial listing fee for common stock is equal to $50,000 plus $0.0032 per share, subject to a minimum of $125,000 and a maximum of $250,000.[164]

On the NYSE Arca, the initial listing fee is $100,000 for a listing of 30 million shares or less; $125,000 for a listing of more than 30 million shares up to and including 50 million shares; and $150,000 for a listing of more than 50 million shares.[165] The initial listing fee is

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[162] See NYSE Equities Listing Fees and NYSE Arca Listing Fees.

[163] In addition to equity securities, separate fee schedules relate to the following classes of securities: (1) Closed-end Funds, (2) Structured Products, (3) Short-term Securities, (4) Investment Company Units, streetTracks® Gold Shares, Currency Trust Shares and Commodity Trust Shares, (5) Foreign Currency Warrants and Currency Index Warrants, Stock Index Warrants and Equity Index-Linked Securities, Commodity-Linked Securities and Currency-Linked Securities Traded on the Equity Floor and (6) Equity-Linked Debt Securities and Equity Index-Linked Securities, Commodity-Linked Securities and Currency-Linked Securities Traded on NYSE Bonds.

[164] The NYSE has a cap of $500,000 for total fees, including initial and annual listing fees, payable in one calendar year.

[165] The NYSE Arca has a cap of $250,000 for total fees, including initial and annual listing fees, payable in one calendar year.

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waived for issuers that transfer their listing from any other national exchange to the NYSE Arca and for issuers that list upon emergence from bankruptcy, or whose primary class of common stock is registered under the 1934 Act but not listed on a national securities exchange.

Annual Fees. On the NYSE, annual listing fees are required on a calendar year basis to maintain the listing. An issuer's annual fees are based on the number of issued and outstanding shares as of December 31 of the previous year. A portion of the annual fee in respect of the first calendar year of the listing, prorated for portion of the calendar year remaining after the initial listing, is due upon the initial listing. The annual fee is equal to the greater of a minimum fee set by the NYSE and a fee calculated on a per share basis, with the minimum fee and the per share fee varying depending on the type of security in question. The annual and per share fees for different types of securities are as follows: (i) for a primary class of common stock or a primary class of preferred stock if no class of common stock is listed, the minimum fee is $42,000 and the per share fee is $0.00093; (ii) for each additional class of common stock, the minimum fee is $20,000 and the per share fee is $0.00093; and (iii) for each additional class of preferred stock, whether the primary class is common or preferred stock, the minimum fee is $5,000 and the per-share fee is $0.00093.[166]

On the NYSE Arca, the annual fee is (i) $30,000 for up to 10 million shares; (ii) $30,000 plus $0.000375 per share for each share above 10 million shares up to and including 100 million shares; and (iii) $85,000 for more than 100 million shares.[167] The annual fee for the first year of a listing will be prorated based on days listed in that calendar year.

Fees for Listing of Additional Shares. If an issuer lists additional shares of a class of securities that is already listed on NYSE, it is required to pay certain fees, calculated as follows: (i) $0.0048 per share for up to and including 75 million additional shares; (ii) $0.00375 per share for more than 75 million additional shares up to and including 300 million additional shares; and (iii) $0.0019 per share for over 300 million additional shares. For purposes of calculating the foregoing fees, the number of additional shares listed is determined on a cumulative basis and therefore takes into account any previous listing of additional shares from the same class.

The NYSE Arca follows the same fee schedule as the NYSE with regard to listing additional shares, and calculates the fee for listing additional shares in the same way as the NYSE.

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[166] *Supra* note 164.

[167] *Supra* note 165.

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NYSE and NYSE Arca Standards for Listing Equity Securities

As noted above, U.S. issuers must qualify for listing on the NYSE and NYSE Arca under the NYSE U.S. Listing Standards, including both distribution and financial criteria.

***NYSE Initial Standards for Listing Equity Securities*.** In order to list equity securities on the NYSE, an issuer must, at the time of initial listing, meet the following distribution requirements:

- it must have at least 400 round lot holders[168] in the United States, which includes beneficial holders of stock held in "street name," as well as holders of record; and
- it must also have at least 1.1 million publicly-held shares in the United States with an aggregate market value in excess of $100 million ($40 million in the case of issuers that list at the time of their IPO, as a result of a spin-off or under the NYSE's affiliated company standard).

The issuer also must meet one of the following financial standards:

- its pre-tax income must total at least $10 million in the aggregate for the latest three fiscal years, the third of which must be profitable, with at least $2 million of pre-tax income for each of the two most recent fiscal years; or
- its pre-tax income must total at least $12 million in the aggregate for the last three fiscal years, with at least $5 million of pre-tax income in the most recent year and at least $2 million of pre-tax income in the next most recent year; or
- it must have at least $500 million of market capitalization, with at least $100 million in revenues in the most recent twelve-month period and aggregate cash flow of $25 million for the last three years, all of which must be profitable; or
- it must have at least $750 million of market capitalization and at least $75 million of revenues during the most recent fiscal year; or
- it must have at least $500 million of market capitalization, have been operating for at least twelve months, and have a parent or an affiliated company that is listed and is in good standing, and the parent or affiliated listed company must retain control of the issuer or be under common control with the issuer; or
- it must have at least $150 million of market capitalization, with at least $75 million in total assets and $50 million in stockholders' equity.

[168] A "round lot" means 100 shares.

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NYSE Arca Initial Standards for Listing Equity Securities. In order to list equity securities on the NYSE Arca, an issuer must, at the time of initial listing, meet the following distribution requirements:

- at least 1.0 million publicly-held shares;
- an initial public offering price per share of $5 or more (if the issuer is listing in conjunction with an initial public offering) or a closing price per share of $5 or more (currently traded issuers must meet this requirement on the basis of a ninety-day average of the closing price of their common stock prior to applying for listing and such closing price cannot fall below $1 per share during the ninety-day period before applying for listing);
- a minimum of 400 round lot holders;
- a market value of publicly-held shares of at least $45 million; and
- at least $150 million in total market capitalization (currently traded issuers must meet this requirement on the basis of a ninety-day average of the closing price of their common stock prior to applying for listing).

The issuer must also meet **two** of the following four financial conditions:

- it must have total assets of at least $75 million;
- it must have at least $50 million in revenues for the most recent fiscal year (or two of the last three years);
- it must have shareholders' equity of at least $50 million;
- its pre-tax income must be positive for the latest fiscal year.

Information Required by the NYSE. In order to conduct a confidential eligibility review, the NYSE requires an issuer to provide it with the following information (where applicable):

- certified copy of the corporate charter and bylaws;
- specimens of stock certificates;
- the issuer's annual reports to shareholders for the last five years, including two copies of the latest report;
- the latest available prospectus covering an offering under the 1933 Act and latest Form 10-K filed with the SEC;

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- the proxy statement for the most recent annual meeting;
- a distribution schedule for the issuer's securities on the NYSE's form; and
- supplementary data to assist the NYSE in determining the character of the share distribution and the number of publicly-held shares, which includes the following information (where applicable):
    - identification of 10 largest holders of record, including beneficial owners (if known);
    - list of holdings of 1,000 shares or more in the names of NYSE member organizations;
    - Nasdaq or other registered securities exchanges' volume and price range during each of the last two years;
    - summary, by principal groups, of stock owned or controlled by:
        - directors or other officers and their immediate families; or
        - other concentrated holdings of 10% or more.
    - shares held under investment letters and not otherwise reported in the summary of stock owned referred to above;
    - estimate of number of non-officer employees owning stock and the total shares held; and
    - shares held in profit-sharing, savings, pension, or other similar funds or trusts established for benefit of officers, employees, etc. (issuers must also indicate the basis on which employees' participation is allocated or vested, circumstances under which employees may receive company shares, and provision for "pass through" of voting rights to employees or other methods of voting shares).

If the NYSE determines that an issuer is eligible to list on the NYSE, the issuer must provide additional supporting documentation at least one week before the date on which the NYSE is to take action on the application. The additional documentation required by the NYSE includes the following (where applicable):

- a signed copy of the listing application and five conformed copies;
- a copy of the charter, certified by the secretary of the state/country of incorporation, and copy of the bylaws, certified by the secretary of the company;

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- a certified copy of appropriate resolutions of the board of directors and, if necessary, stockholders;

- copies of opinions of counsel filed in connection with recent public offerings, or if no opinions of counsel exist, a certificate of good standing from the issuer's jurisdiction of incorporation;

- a signed copy of a stock distribution schedule showing the distribution of each class of shares for which listing application is made;

- a certificate of the registrar certifying the number of shares of the class or series for which listing application is made;

- specimens of certificates representing the securities;

- copies of any prospectus under the 1933 Act within the past year relating to the securities proposed for listing;

- the issuer's financial statements, including the report of the issuer's independent public accountants or, in the case of interim statements, the report of the issuer's chief financial officer;

- any adjustments to historical financial data submitted by the issuer during the financial eligibility review process that are required by the NYSE;

- a listing agreement executed by the an authorized officer;

- a memorandum with respect to unpaid dividends, unsettled rights and record dates; and

- a registration statement under the 1934 Act.

Information Required by NYSE Arca. In order to conduct a confidential eligibility review, the NYSE Arca requires an issuer to provide it with the following information:

- if the listing is for an initial public offering:
    - an executed listing application;
    - the issuer's latest registration statement and exhibits;
    - the SEC's comments and responses; and
    - a $500 application fee.

- if the listing is not for an initial public offering:

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- an executed listing application;
- the issuer's latest Form 10-K and 10-Q filings with the SEC;
- the issuer's latest proxy statement and, if applicable, latest prospectus;
- the past six-months' trading history of the securities; and
- a $500 application fee.

Upon approval by the NYSE Arca, the issuer must submit additional documentation, such as:

- opinion of counsel as to issuer's compliance with certain corporate governance requirements;
- articles of incorporation and bylaws of the issuer and board resolutions approving the listing;
- registrar/transfer agent agreement; and
- specimens of certificates representing the securities.

If the listing is for an initial public offering, the NYSE Arca will also require an issuer to submit, after trading has started, a distribution schedule, signed by an executive officer, that identifies the issuer's beneficial holders.

NYSE and NYSE Arca Corporate Governance Requirements

Each of the NYSE and the NYSE Arca has established policies and requirements concerning certain corporate governance practices, such as structure and composition of the board of directors, shareholder approval and related requirements.[169]

NYSE Corporate Governance Requirements. The NYSE corporate governance standards are set out in Section 303A of the NYSE Listed Company Manual ("Section 303A"), and, subject to exceptions,[170] require a listed issuer to:

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[169] See NYSE Corporate Responsibility and NYSE Arca Corporate Governance and Disclosure Policies.

[170] The NYSE makes exceptions from these corporate governance rules for certain issuers, including controlled companies (companies where more than 50% of the voting power is held by an individual, a group or another company), limited partnerships, companies in bankruptcy, closed-end and open-end funds, certain passive business organizations in the form of trusts and foreign private issuers, as well as for derivatives and special purpose securities. Each of these types of issuers and securities is exempt from certain of the corporate governance rules.

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- have a majority of independent directors;[171]
- have regularly scheduled executive sessions in which non-management directors meet without management participation;
- have a nominating/corporate governance committee composed entirely of independent directors;[172]
- have a compensation committee composed entirely of independent directors;[173]
- have an audit committee that has at least three members, satisfies the independence requirements of Rule 10A-3 under the 1934 Act, and consists solely of independent directors who have the requisite financial experience and expertise;[174]
- provide shareholders the opportunity to vote on all equity compensation plans and material revisions thereto, with certain limited exemptions;[175]
- adopt and disclose corporate governance guidelines;

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[171] An issuer listing in conjunction with its initial public offering is required to meet the majority independent board requirements within twelve months of listing and is permitted to phase in its independent nominating/corporate governance, audit and compensation committees on the following schedule: one independent member of each committee at the time of listing, a majority of independent members of each committee within ninety days of listing, and fully independent committees within one year of listing. The NYSE will also permit issuers that are emerging from bankruptcy or have ceased to be controlled companies (as defined below) to phase in independent nominating/corporate governance and compensation committees (but not audit committees) and majority independent boards on the same schedule as issuers listing in conjunction with an initial public offering. An issuer of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company (a "controlled company"), a limited partnership and any company in bankruptcy need not have a majority of independent directors on its board or have nominating/corporate governance and compensation committees composed solely of independent directors as described in Section 303A.0 of the NYSE Listed Company Manual. However, all such controlled companies, limited partnerships and companies in bankruptcy must have an audit committee that has at least three members, satisfies the independence requirements of Rule 10A-3 under the 1934 Act, and consists solely of independent directors who have the requisite financial experience and expertise.

[172] *Id.*

[173] *Id.*

[174] *Id.*

[175] Shareholder approval is not required for employment inducement awards, certain grants, plans and amendments in the context of mergers and acquisitions, and certain specific types of plans, as described in Section 303A of the NYSE Listed Company Manual.

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- adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers;

- provide to the NYSE each year a certification by the issuer's CEO that he or she is not aware of any violation by the issuer of NYSE corporate governance listing standards, which certification can be qualified to the extent necessary;

- promptly notify the NYSE in writing after any executive officer becomes aware of non-compliance with any applicable provision of Section 303A;

- submit an executed written affirmation annually to the NYSE stating that the issuer is in compliance with the NYSE corporate governance rules and an interim written affirmation stating the same each time a change occurs to the board or any of the committees subject to Section 303A;

- have and maintain a publicly accessible web site;

- make available to shareholders and the NYSE its annual financial reports filed with the SEC, disseminate its interim earnings release to shareholders[176] and notify the NYSE when there is a change in certain important aspects of the issuer's business, such as a change in auditors, directors or executive officers, dividends and stock distributions or business purpose; and

- immediately disclose to the public material developments which might reasonably be expected to affect the market for the issuer's securities or to dispel unfounded market rumors which result in unusual market activity or price variations pursuant to the procedure set forth in NYSE Listed Company Manual Section 202.06.[177]

For the purposes of Section 303A, a director does not qualify as independent unless the board of directors of the issuer has made an affirmative determination that such director has no material relationship with the issuer, either directly or as a partner, shareholder or officer of an organization that has a relationship with the issuer. Furthermore, a director does not qualify as independent under Section 303A if:

- such director is, or has been within the last three years, an employee of the issuer, or an immediate family member is, or has been within the last three years, an executive officer of the issuer;

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[176] The distribution of its interim earnings release to shareholders is recommended, not required, by the NYSE.

[177] See NYSE Listed Company Manual Section 202.06.

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- such director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than $120,000 in direct compensation from the issuer, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service);

- (A) such director is a current partner of a firm that is the issuer's internal or external auditor; (B) an immediate family member of such director is a current partner of such a firm; (C) such director has an immediate family member who is a current employee of such a firm and personally works on the issuer's audit; or (D) such director or an immediate family member was within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the issuer's audit within that time;

- such director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the issuer's present executive officers at the same time serves or served on the compensation committee of such other company; or

- such director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the issuer for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million or 2% of such other company's consolidated gross revenues.

NYSE Arca Corporate Governance Requirements. Issuers with securities listed on the NYSE Arca must comply with the corporate governance and disclosure policies established by the NYSE Arca. The corporate governance standards for NYSE Arca are similar to those of the NYSE, are contained in the NYSE Arca Bylaws & Rules,[178] which can be found on NYSE Arca's website,[179] and require all listed issuers, with certain exceptions,[180] to:

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[178] See NYSE Arca Equities Rules.

[179] See www.NYSE.com.

[180] NYSE Arca makes exceptions from these corporate governance rules for certain issuers, including controlled companies (companies where more than 50% of the voting power is held by an individual, a group or another company), limited partnerships, companies in bankruptcy, closed-end and open-end funds, certain passive business organizations in the form of trusts and foreign private issuers, as well as for derivatives and special purpose securities. Each of these types of issuers and securities is exempt from certain of the corporate governance rules.

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- have a majority of independent directors[181]
- have regularly scheduled executive sessions in which non-management directors meet without management participation;
- have a nominating/corporate governance committee composed entirely of independent directors;[182]
- have a compensation committee composed entirely of independent directors;[183]
- have an audit committee that has at least three members, satisfies the independence requirements of Rule 10A-3 under the 1934 Act, and consists solely of independent directors who have the requisite financial experience and expertise;[184]
- provide shareholders the opportunity to vote on all equity-compensation plans and material revisions thereto, with certain limitations,[185] and in circumstances where the issuance will result in a change of control of the issuer;
- adopt and disclose corporate governance guidelines;

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181 An issuer listing in conjunction with its initial public offering is required to meet the majority independent board requirements within twelve months of listing and is permitted to phase in its independent nominating/corporate governance, audit and compensation committees on the following schedule: one independent member of each committee at the time of listing, a majority of independent members of each committee within ninety days of listing and fully independent committees within one year of listing. NYSE Arca will also permit issuers that are emerging from bankruptcy or have ceased to be controlled companies (as defined below) to phase in independent nominating/corporate governance and compensation committees (but not audit committees) and majority independent boards on the same schedule as issuers listing in conjunction with an initial public offering. An issuer of which more than 50% of the voting power is held by an individual, a group or another company (a "controlled company"), a limited partnership and any company in bankruptcy need not have a majority of independent directors on its board or have nominating/corporate governance and compensation committees composed solely of independent directors as described in Rule 5.3(k) of NYSE Arca's Bylaws & Rules. However, all such controlled companies, limited partnerships and companies in bankruptcy must have an audit committee that has at least three members, satisfies the independence requirements of Rule 10A-3 under the 1934 Act, and consists solely of independent directors who have the requisite financial experience and expertise.

182 *Id.*

183 *Id.*

184 *Id.*

185 Shareholder approval is not required for employee inducement awards, certain grants, plans and amendments in the context of mergers and acquisitions, and certain specific types of plans, as described in Rule 5.3 of the NYSE Arca Bylaws & Rules.

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- adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors and executive officers;

- provide to NYSE Arca each year a certification by the issuer's CEO that he or she is not aware of any violation by the issuer of NYSE Arca corporate governance standards, qualifying the certification to the extent necessary;

- promptly notify NYSE Arca in writing after any executive officer becomes aware of non-compliance with any applicable provision of Rule 5.3 of the NYSE Arca's Bylaws & Rules;

- submit an executed written affirmation annually to the NYSE Arca stating that the issuer is in compliance with NYSE Arca corporate governance rules and an interim written affirmation stating the same each time a change occurs to the board or any of the committees;

- distribute to shareholders and NYSE Arca annual reports containing audited financial statements, proxy statements and other soliciting materials, notify NYSE Arca of proposed amendments to its certificate of incorporation or bylaws, material changes in accounting practices, information regarding dividends, periodic filings made to the SEC, and other such information, as required by Rule 5.3 of NYSE Arca's Bylaws & Rules;

- immediately disclose in the form and method described in Rule 5.3 of NYSE Arca's Bylaws & Rules information about the issuer or about events or conditions in the market for its securities when the information is likely to have a significant effect on the price of any of the issuer's securities, or such information is likely to be considered important by a reasonable investor in determining a choice of action; and

- eliminate material conflicts of interest between officers, directors or principal shareholders and the issuer prior to approval of the listing.

For purposes of NYSE Arca Rule 5.3(k), a director does not qualify as independent unless the board of directors of the issuer has made an affirmative determination that such director has no material relationship with the issuer, either directly or as a partner, shareholder or officer of an organization that has a relationship with the issuer. Furthermore, a director does not qualify as independent under Rule 5.3(k) if:

- such director is, or has been within the last three years, an employee of the issuer, or an immediate family member of such director is or has been within the last three years an executive officer of the listed company;

- such director has received, or an immediate family member of such director has received, during any twelve-month period within the last three years, more than

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$100,000 in direct compensation from the issuer, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service);

- (A) such director or an immediate family member of such director is a current partner of a firm that is the issuer's internal or external auditor; (B) such director is a current employee of such a firm; (C) such director has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance or tax compliance (but not tax planning) practice; or (D) such director or an immediate family member was within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the issuer's audit within that time;

- such director or an immediate family member is, or in the past three years has been, part of an interlocking directorate in which an executive officer of the listed company serves or served on the compensation committee of another company that concurrently employs or employed the director; or

- such director is an executive officer or an employee, or an immediate family member of such director is an executive officer, of a company that makes payments to, or receives payments from, the issuer for property or services in an amount which, in any single fiscal year, exceeds the greater of $200,000 or 5% of such other company's consolidated gross revenues (such director will be deemed independent three years after falling below such threshold).

NYSE Shareholder Approval Requirements. The NYSE requires shareholder approval for:

- the adoption of equity compensation plans and material revisions thereto, with limited exceptions;

- the issuance of common stock or securities convertible into or exercisable for common stock to a director, officer or substantial security holder[186] of an issuer (a "Related Party"), a subsidiary, affiliate or other closely-related person of a Related Party or any company or entity in which a Related Party has a substantial direct or indirect interest if the number of shares of common stock to be issued or the number of shares of common stock into which the securities may be

[186] Pursuant to § 312.04(e) of the NYSE Listed Company Manual, a substantial security holder is a security holder who holds at least 5% of the issuer's common stock or at least 5% of the issuer's outstanding voting power.

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convertible or exercisable exceeds either 1% of the number of shares of common stock or 1% of the voting power outstanding before the issuance;[187]

- the issuance of common stock or securities convertible into common stock, in any one transaction or a series of related transactions, other than a public offering for cash or a *bona fide* private financing,[188] if that issuance could result in (1) an increase in voting power of 20% or more or (2) an increase in the amount of outstanding common stock of 20% or more; or

- the issuance of securities that will result in a change of control of the issuer.

NYSE Arca Shareholder Approval Requirements. The NYSE Arca requires shareholder approval for:

- the adoption of equity compensation plans and material revisions thereto, with limited exceptions;

- the issuance of securities that will result in a change of control of the issuer;

- in connection with the acquisition of the shares or assets of another company:

  - if any director, officer or substantial security holder of the issuer has a 5% or greater interest (or such persons collectively have a 10% or greater interest), directly or indirectly, in the company or assets to be acquired or in the consideration to be paid in the transaction or series of related transactions, and the present or potential issuance of common stock or securities convertible into or exercisable for common stock, could result in an increase in voting power or in the amount of outstanding common stock of 5% or more; or

  - where the present or potential issuance of common stock, or securities convertible into or exercisable for common stock, other than a public offering for cash, could result in (i) an increase in voting power of 20% or more or (ii) an increase in the amount of outstanding common stock of 20% or more;

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[187] If a Related Party is classified as such solely because such person is a substantial security holder, and a sale of stock is for cash at a price at least as great as each of the book and market value of the issuer's common stock, then shareholder approval is not required. However, this exception becomes inapplicable if the number of shares of common stock to be issued or the number of shares of common stock into which the securities to be issued may be convertible or exercisable exceeds either 5% of the number of outstanding shares of common stock or 5% of the voting power outstanding before the issuance.

[188] A *bona fide* private financing involves a sale of: (i) common stock, for cash, at a price at least as great as each of the book and market value of the issuer's common stock or (ii) securities convertible into or exercisable for common stock, for cash, if the conversion or exercise price is at least as great as each of the book and market value of the issuer's common stock, in each case, at the time of such sale.

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- in connection with a transaction other than a public offering:
  - the sale or issuance by the issuer of common stock or securities convertible into or exercisable for common stock at a price less than the greater of book or market value, which together with sales by officers, directors or principal shareholders of the issuer equals 20% or more of presently outstanding common stock or 20% or more of presently outstanding voting power; or
  - the sale or issuance by the issuer of common stock or securities convertible into or exercisable for common stock equal to 20% or more of presently outstanding stock or voting power for less than the greater of book or market value of the issuer's common stock at the time of such sale.

Rights Offerings

The NYSE sets forth certain requirements with respect to short-term rights offerings related to listed securities. Due to the potential complexity of rights offerings, the NYSE recommends that issuers confer with NYSE representatives well in advance of the offering date to discuss compliance with these requirements.

NYSE and NYSE Arca Continued Listing Requirements

NYSE. Listed issuers must continue to comply with certain ongoing requirements of the NYSE in order to maintain the securities listing on the NYSE. An issuer that falls below the requirements under which it originally listed will be considered to be out of compliance. The NYSE will consider delisting a listed security under the following circumstances:[189]

- the extent of public distribution has declined below certain levels;

[189] Certain other events may also cause an issuer's securities to be delisted, including the following: (1) the issuer, its transfer agent or registrar violates any of the listing or other agreements with the NYSE; (2) the entire class, issue or series of listed securities is repaid, redeemed or retired; (3) the issuer's interest coverage of debt securities becomes inadequate or its operations are not properly financed; (4) the issuer fails to make timely, adequate and accurate disclosure of information to its shareholders and the investing public; (5) the issuer fails to observe sound accounting practices in reporting of earnings and financial position; (6) the issuer participates in other conduct not in keeping with sound public policy; (7) the financial condition or operating results of the issuer are unsatisfactory; (8) the selling price or volume of trading with respect to listed securities of the issuer is abnormally low; (9) the issuer makes unwarranted use of its funds for the repurchase of its equity securities; (10) the issuer's audit committee is not maintained in accordance with Rule 10A-3 under the 1934 Act; (11) the most recent independent public accountant's opinion on the financial statements contains a qualified opinion, an adverse opinion, a disclaimer opinion or an unqualified opinion with a "going concern" emphasis; (12) the issuer demonstrates an inability to meet current debt obligations or to adequately finance operations; or (13) any other event or condition that makes further dealings or listing of the securities on the NYSE inadvisable or unwarranted in the opinion of the NYSE.

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- the issuer's operating assets have been, or are to be, substantially reduced such as by sale, lease, spin off, discontinuance, destruction, condemnation, abandonment, seizure or expropriation, or the issuer has ceased to be an operating company or has discontinued a substantial portion of its operations for any reason whatsoever, whether or not this results from actions by the issuer, related parties, or persons unrelated to the issuer;

- the issuer's intention to file under any of the sections of applicable bankruptcy law has been announced or a filing has been made, or liquidation has been announced and the issuer is committed to proceed;

- the issuer's registration or exemption from registration pursuant to the 1934 Act is no longer effective for any reason; or

- advice has been received, and deemed by the NYSE to be authoritative, that the security is without value.

NYSE Arca. Listed issuers must continue to comply with certain requirements of the NYSE Arca in order to maintain the securities listing on the NYSE Arca. The NYSE Arca will consider delisting a listed security in circumstances substantially similar to those discussed above under which the NYSE will consider delisting a listed security. Additional information on the NYSE Arca initial and continuing listing standards, fees, and other matters relating to listing securities on the NYSE Arca can be found in the NYSE Arca Equities Rules.[190]

LISTING EQUITY SECURITIES ON THE NYSE MKT

Like the NYSE, the NYSE MKT has established certain numerical guidelines, outlined below, which are considered in evaluating listing eligibility. In addition to these criteria, in making listing determinations the NYSE MKT considers other factors, including the nature of an issuer's business, the market for its products, its regulatory history, its past corporate governance activities, the reputation of its management, its historical record and pattern of growth, its financial integrity, its demonstrated earnings power and its future outlook.

NYSE MKT Process for Listing Equity Securities

In accordance with the NYSE MKT listing procedures, an issuer must submit a listing application that meets certain initial listing standards (the "NYSE MKT Initial Listing Standards"). The NYSE MKT has a confidential pre-application eligibility review process.

[190] See NYSE Arca Equities Rules.

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Additional information on NYSE MKT listing standards, fees and other matters relating to listing securities on the NYSE MKT can be found in the NYSE MKT Company Guide.[191]

NYSE MKT Fees for Listing Equity Securities

Initial Fees. The fees for a U.S. issuer initially listing shares on the NYSE MKT are $50,000 for the listing of fewer than 5 million shares; $55,000 for the listing of 5 million shares up to and including 10 million shares; $60,000 for the listing of more than 10 million shares up to and including to 15 million shares; and a fee of $75,000 for the listing of more than 15 million shares.

Annual Fees. Annual fees range from a minimum fee of $30,000 to a maximum fee of $45,000 based on the number of shares outstanding. Upon the original listing, an issuer must also pay a prorated portion of the annual fee, based upon the portion of the calendar year remaining after the listing.

Fees for Listing of Additional Shares. Listing of additional shares subsequent to original listing–$.02 per share subject to a minimum fee of $2,000 (100,000 shares or less) and a maximum fee of $45,000 (2,250,000 shares or more) per application. The annual maximum fee per issuer for listing additional shares is $65,000.

NYSE MKT Standards for Listing Equity Securities

As noted above, U.S. issuers must qualify for listing on the NYSE MKT under the NYSE MKT Initial Listing Standards, including both distribution and financial criteria.

NYSE MKT Initial Listing Standards. In order to list equity securities on the NYSE MKT, an issuer must satisfy one of the following distribution requirements:[192]

- 500,000 publicly-held shares in the United States and a minimum of 800 U.S. public shareholders;
- one million publicly-held shares in the United States and a minimum of 400 U.S. public shareholders; or
- 500,000 publicly-held shares in the United States and a minimum of 400 U.S. public shareholders and average daily trading volume of 2,000 shares or more for the six months preceding the date of the application.[193]

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[191] See NYSE MKT Company Guide.

[192] The exchange may also consider the listing of the securities of a bank that has a minimum of 500,000 publicly-held shares and a minimum of 400 public shareholders. Furthermore, there are additional criteria for closed-end investment companies registered under the 1940 Act seeking to list shares. See Section 101(g) of the NYSE MKT Company Guide.

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An issuer must also satisfy one of the following financial standards:

- stockholders' equity of at least $4 million, pre-tax income of at least $750,000 in its last fiscal year or in two of its last three fiscal years and an aggregate market value of publicly-held shares of $3 million with a minimum market price of $3.00 per share;

- stockholders' equity of at least $4 million, at least two years of operation and an aggregate market value of publicly-held shares of $15 million with a minimum market price of $3.00 per share;

- stockholders' equity of at least $4 million, market capitalization of $50 million and an aggregate market value of publicly-held shares of $15 million with a minimum market price of $2.00 per share; or

- market capitalization of $75 million, or total assets and total revenue of $75 million each in its last fiscal year, or in two of its last three fiscal years, and an aggregate market value of publicly-held shares of $20 million with a minimum market price of $3.00 per share.

Information Required by the NYSE MKT. In order to conduct an eligibility review, the NYSE MKT requires a U.S. issuer to provide it with the following information (as applicable):

- the listing application;

- a copy of:

  - the registration statement for the securities to be listed on SEC Form 8-A or Form 10 registering the securities under Section 12(b) of the 1934 Act;

  - the latest Form 10-K report and Form 10-Q reports and Form 8-K reports for periods subsequent to the latest Form 10-K (or comparable periodic reports filed with the appropriate regulatory agency of the issuer pursuant to the 1934 Act), and the latest proxy statement for the annual meeting of stockholders; or

  - a prospectus declared effective by the SEC which contains the latest audited financial statements of the issuer, any Form 10-Q reports and Form 8-K reports (or comparable periodic reports filed with the appropriate regulatory

[193] Note that, in evaluating the suitability of a security for listing under this provision, the exchange will review the nature and frequency of trading activity and such other factors as it may determine to be relevant in ascertaining whether such security is suitable for auction market trading. A security that trades infrequently will not be considered for listing under this provision even though average daily volume amounts to 2,000 shares per day or more.

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agency of the issuer pursuant to the 1934 Act), for periods subsequent to the effective date of the prospectus, and latest available proxy statement for the meeting of stockholders;

- a copy of the latest annual report distributed to stockholders;

- a copy of such other information, documents or materials as may be deemed appropriate by the NYSE MKT for inclusion in the issuer's listing application;

- the issuer's financial statements may be submitted to the NYSE MKT's consulting accountants for review as to compliance with the NYSE MKT requirements and generally accepted accounting principles;

- any additional information or documentation, public or non-public, the NYSE MKT may deem necessary to make a determination regarding a security's initial listing eligibility, including, but not limited to, any material provided to or received from the SEC or other appropriate regulatory authority;

- the listing fee discussed above; and

- a copy of the executed listing agreement, a form of which is provided by the exchange.

NYSE MKT Corporate Governance Requirements. The NYSE MKT has established policies and requirements concerning certain corporate governance practices, such as structure and composition of the board of directors, shareholder approval and related requirements. The NYSE MKT's governance rules are substantially identical to those of the NYSE.

The corporate governance standards are set out in Part 8 of the NYSE MKT Company Guide ("Part 8")[194] which provides (subject to exceptions),[195] among other things, that:

- the issuer must have a majority of independent directors;[196]

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[194] See NYSE MKT Company Guide Part 8.

[195] NYSE MKT makes exceptions from these corporate governance rules for certain issuers, including controlled companies (companies where more than 50% of the voting power is held by an individual, a group or another company), limited partnerships, companies in bankruptcy, closed-end and open-end funds, certain passive business organizations in the form of trusts and foreign private issuers, as well as for derivatives and special purpose securities. Each of these types of issuers and securities is exempt from certain of the corporate governance rules.

[196] An issuer listing in conjunction with its initial public offering is required to meet the majority independent board requirements within 12 months of listing and is permitted to phase in its independent audit committee and, if it elects to have a nominating committee and compensation committee (rather than having the
(continued)

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- the independent directors must meet on a regular basis and at least annually in executive session without the presence of non-independent directors and management;

- board of director nominations must be either selected, or recommended for the board's selection, by either a nominating committee comprised solely of independent directors or by a majority of the independent directors;[197,198]

- compensation of the chief executive officer of the issuer must be determined, or recommended to the board for determination, either by a compensation committee comprised of independent directors or by a majority of the independent directors;[199]

- the issuer must have an audit committee that has at least three members (or at least two members, in the case of a small business issuer), satisfies the independence requirements of Rule 10A-3 under the 1934 Act and consists solely of independent directors who have the requisite financial experience and expertise;[200]

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functions of those committees discharged by a majority of the independent directors) its independent nominating and compensation committees on the following schedule: one independent member of each committee at the time of listing, a majority of independent members of each committee within ninety days of listing and fully independent committees within one year of listing. The NYSE MKT will also permit issuers that are emerging from bankruptcy or have ceased to be controlled companies (as defined below) to phase in independent nominating and compensation committees (but not audit committees) and majority independent boards on the same schedule as issuers listing in conjunction with an initial public offering. An issuer of which more than 50% of the voting power is held by an individual, a group or another company (a "controlled company"), a limited partnership and any company in bankruptcy need not have a majority of independent directors on its board and, if it elects to have a nominating or compensation committee, need not have those committees composed solely of independent directors, as described in Section 801 of the NYSE MKT Company Guide. However, all such controlled companies, limited partnerships and companies in bankruptcy must have an audit committee that has at least three members (or at least two members, in the case of a small business issuer), satisfies the independence requirements of Rule 10A-3 under the 1934 Act and consists solely of independent directors who have the requisite financial experience and expertise.

[197] *Id.*

[198] Issuers listing on the NYSE MKT may choose not to have a compensation or nominations committee and may instead rely upon a majority of the independent directors to discharge the responsibilities of these committees.

[199] *Supra* note 196; *supra* note 198.

[200] *Supra* note 196.

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- approval of shareholders is required with respect to stock option and equity compensation plans and material revisions thereto, with certain limited exemptions;[201]

- the issuer must adopt and make publicly available a code of conduct and ethics, applicable to all directors, officers and employees, which also complies with the definition of a "code of ethics" as set forth in Item 406 of Regulation S-K;

- the issuer must promptly notify the NYSE MKT after any executive officer becomes aware of non-compliance with any applicable provision of Part 8; and

- the issuer must not appoint or permit an NYSE MKT employee or floor member to serve on its board of directors.

For the purposes of Part 8, an independent director means a person other than an executive officer or employee of the issuer in respect of whom the board of directors of the issuer has made an affirmative determination that such director does not have a relationship that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. Furthermore, the following persons may not be deemed as independent:

- a director who is, or during the past three years was, employed by the issuer, other than prior employment as an interim executive officer for a period of not longer than one year;

- a director who accepted or has an immediate family member who accepted compensation from the issuer in excess of $120,000 during any twelve-month period within the last three years, other than (i) compensation for board or board committee service, (ii) compensation to an immediate family member who is an employee (other than an executive officer) of the issuer, (iii) compensation for former service as an interim executive officer for a period of not longer than one year or (iv) benefits under a tax-qualified retirement plan, or non-discretionary compensation;

- a director who is an immediate family member of an individual who is, or at any time during the past three years was, employed by the issuer as an executive officer;

[201] Shareholder approval is not required for (i) employment inducement awards; (ii) certain tax-qualified, non-discriminatory employee benefit plans or parallel nonqualified plans; (iii) plans and arrangements relating to mergers and acquisitions; and (iv) warrants or rights issued generally to all security holders of the issuer or stock purchase plans available on equal terms to all security holders of the issuer. However, the exempt awards and plans described in clauses (i) and (ii) above may be made only with the approval of the issuer's independent compensation committee or the approval of a majority of the independent directors. Issuers must also notify the NYSE MKT in writing when they use any of the exemptions in clauses (i) through (iv).

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- a director who is, or has an immediate family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the issuer made, or from which the issuer received, payments (other than those arising solely from investments in the issuer's securities or payments under non-discretionary charitable contribution matching programs) that exceed the greater of (i) 5% of the organization's consolidated gross revenues for that year, or (ii) $200,000, in any of the most recent three fiscal years;

- a director who is, or has an immediate family member who is, employed as an executive officer of another entity where at any time during the most recent three fiscal years any of the issuer's executive officers served on the compensation committee of such other entity; or

- a director who is, or has an immediate family member who is, a current partner of the issuer's outside auditor, or was a partner or employee of the issuer's outside auditor who worked on the issuer's audit at any time during any of the past three years.

A director who is not independent under the NYSE MKT's definition, but who satisfies the independence requirements of Rule 10A-3 under the 1934 Act, and is not a current officer or employee or an immediate family member of such officer or employee, may still be appointed to the audit committee for a non-chairperson position for no more than two consecutive years, if the board of the issuer determines, under exceptional and limited circumstances, that such director's membership on the audit committee is required by the best interests of the issuer and its shareholders, and the issuer discloses, in the proxy statement for its next shareholders' meeting, the nature of the relationship and the reason for the determination.

NYSE MKT Shareholder Approval Requirements. The NYSE MKT requires shareholder approval for:

- the adoption of equity compensation plans and material revisions thereto, with limited exceptions;

- the issuance of securities that will result in a change of control of the issuer;

- in connection with the acquisition of the shares or assets of another company:

  - if any director, officer or substantial security holder of the issuer has a 5% or greater interest (or such persons collectively have a 10% or greater interest), directly or indirectly, in the company or assets to be acquired or in the consideration to be paid in the transaction or series of related transactions, and the present or potential issuance of common stock or securities convertible into or exercisable for common stock could result in an increase in voting power or in the amount of outstanding common stock of 5% or more; or

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  - o where the present or potential issuance of common stock, or securities convertible into or exercisable for common stock, other than a public offering for cash, could result in (i) an increase in voting power of 20% or more or (ii) an increase in the amount of outstanding common stock of 20% or more;

- in connection with a transaction other than a public offering:

  - o the sale or issuance by the issuer of common stock or securities convertible into or exercisable for common stock at a price less than the greater of book or market value, which together with sales by officers, directors or principal shareholders of the issuer equals 20% or more of presently outstanding common stock or 20% or more of presently outstanding voting power; or

  - o the sale or issuance by the issuer of common stock or securities convertible into or exercisable for common stock equal to 20% or more of presently outstanding stock or voting power for less than the greater of book or market value of the issuer's common stock.

NYSE MKT Continued Listing Requirements

In considering whether a security warrants continued listing, the NYSE MKT will evaluate numerous factors, such as the degree of investor interest in the issuer, its prospects for growth, the reputation of its management, the degree of commercial acceptance of its products, and whether its securities have suitable characteristics for auction market trading. Any developments which substantially reduce the size of the issuer, the nature and scope of its operations, the value or amount of its securities available for the market, or the number of holders of its securities may subject the issuer to continued listing review by the NYSE MKT. The NYSE MKT will consider the suspension of trading in, or removal from listing of, any security when, in the opinion of the NYSE MKT:

- the financial condition and/or operating results of the issuer appear to be unsatisfactory;

- it appears that the extent of public distribution or the aggregate market value of the security has become so reduced that further dealings on the NYSE MKT are inadvisable;

- the issuer has sold or otherwise disposed of its principal operating assets, or has ceased to be an operating company;

- the issuer has failed to comply with its listing agreements with the NYSE MKT; or

- any other event occurs which makes further dealings on the NYSE MKT unwarranted.

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LISTING EQUITY SECURITIES ON THE NASDAQ MARKETS[202]

FINRA, which administers Nasdaq through its subsidiary, the Nasdaq Stock Market, Inc., has established certain guidelines, outlined below, that are considered in evaluating eligibility for issuers on its three markets: the Nasdaq Capital Market (formerly the Nasdaq SmallCap Market); the Nasdaq Global Market (formerly the Nasdaq National Market); and the Nasdaq Global Select Market. Compared to the Nasdaq Capital Market, the Nasdaq Global Market has higher minimum initial listing standards and requires more trading information about the listed securities to be made publicly available. While the Nasdaq Global Select Market maintains the same continued listing requirements as the Nasdaq Global Market, the Nasdaq Global Select Market claims to have the highest initial financial and liquidity listing qualifications of any securities market in the world.

To list securities on any of the three Nasdaq markets, an issuer must meet the minimum qualifications and other requirements, file an application, sign a listing and listing fee agreement, and pay the initial and continuing listings fees, in each case applicable to that Nasdaq market. The securities to be so listed must be registered under Section 12(b) of the 1934 Act before or concurrently with the listing on any Nasdaq market.

Nasdaq Process for Listing Equity Securities

Application for a Nasdaq listing is made on the applicable form provided by FINRA and signed by a corporate officer of the issuer. FINRA may require the issuer to submit any information that is relevant to a determination of designation as a Nasdaq-listed security.

An issuer may seek a preliminary listing eligibility review by Nasdaq to determine whether it meets the numerical listing requirements and to address specific concerns regarding corporate governance requirements.[203]

Nasdaq Fees for Listing Equity Securities[204]

Initial Listing Fees. For U.S. issuers, the entry fee is based on the aggregate number of shares to be listed at the time of initial listing, regardless of class, plus a one-time, non-refundable application fee of $5,000 for the Nasdaq Capital Market, $25,000 for the Nasdaq Global Market, and $25,000 for the Nasdaq Global Select Market. On the Nasdaq Capital Market, the entry fee is $50,000 for up to and including 15 million shares and $75,000 for listings over 15 million shares. On the Nasdaq Global Market and the Nasdaq Global Select Market, the entry fee is $125,000 for up to and including 30 million shares; $150,000 for greater than 30 million up to and including 50 million shares; $200,000 for greater than 50

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[202] See http://nasdaq.cchwallstreet.com/ for a link to the Nasdaq Stock Market Rules.

[203] Issuers interested in a preliminary review should contact Nasdaq at the office of New Listings and Capital Markets (phone: (212) 401-8724; email: bob.mccooey@nasdaqomx.com).

[204] See Listing Fees for Nasdaq Equity Securities.

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million up to and including 100 million shares; and $225,000 over 100 million shares. Issuers already listed on Nasdaq must follow the same application procedures to list a new class of securities.

Certain filings are exempt from entry fees. There is no application or entry fee for an issuer transferring its listing from the Nasdaq Capital Market to the Nasdaq Global Market if it was listed on the Nasdaq Capital Market prior to January 1, 2007, or if it was listed after January 1, 2007 but did not qualify for the Nasdaq Global Market at the time of its initial listing. Any other issuer transferring its listing from the Nasdaq Capital Market to the Nasdaq Global Market must pay the entry fees, but not the application fees, for the Nasdaq Global Market, less the fees paid for listing on the Nasdaq Capital Market. There is also no application or entry fee for an issuer transferring its listing from the Nasdaq Global Market to the Nasdaq Global Select Market. Furthermore, there is no application or entry fee for securities that are transferred from another national securities exchange to list exclusively on the Nasdaq Stock Market. Where an issuer listed on another securities exchange is acquired by an unlisted company, and in connection with such acquisition, the unlisted company lists exclusively on Nasdaq, this listing is also exempt from the application fee and the entry fee. Lastly, there is no charge for securities of an issuer that has a dual listing on the NYSE and a Nasdaq market.

Annual Fees. Annual fees for the Nasdaq Global Market and Nasdaq Global Select Market are based on the issuer's total shares outstanding for all classes of stock listed as shown in the issuer's most recent periodic report filed with the SEC or in any more recent information held by Nasdaq. On the Nasdaq Capital Market, the annual fee is $32,000. On the Nasdaq Global Market and the Nasdaq Global Select Market, the annual fee is $35,000 for up to 10 million shares; $37,500 for 10 to 50 million shares; $46,500 for 50 to 75 million shares; $68,500 for 75 to 100 million shares; $89,000 for 100 to 150 million shares; and $99,500 for over 150 million shares. For Nasdaq's three markets, in the first year of listing the issuer's annual fee will be prorated based on the month of listing.

Fees for Listing Additional Shares. Issuers must pay a fee in connection with the issuance of additional shares. For U.S. issuers, there is no fee for the issuance of up to 49,999 additional shares per quarter, and a fee equal to the greater of $5,000 or $0.01 per share for the issuance of 50,000 or more additional shares per quarter, subject to an annual fee cap of $65,000. This fee is the same for all three of the Nasdaq markets. The fee is assessed quarterly based on the issuer's total shares outstanding as reported in its periodic reports filed with the SEC.

Issuers that list securities on both the NYSE and the Nasdaq Stock Market are not required to pay a fee for issuing additional shares. This provision does not apply to other dual listings.

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Nasdaq Standards for Listing Equity Securities[205]

Nasdaq Initial Listing Standards. Issuers must meet distribution and financial requirements specific to the Nasdaq market on which listing is sought.

To qualify an initial listing on the Nasdaq Capital Market, an issuer must have at least one million publicly-held shares (excluding shares held by any officers, directors, or 10% shareholders), 300 round lot holders,[206] three market makers, and a minimum $4 bid price. Additionally, the issuer must meet one of the following three financial standards:

- stockholders' equity of $5 million, a $15 million market value of publicly-held shares ("MVPHS"), and an operating history of two years;
- stockholders' equity of $4 million, a $15 million MVPHS, and a $50 million market value for listed securities (Nasdaq or other national securities exchange); or
- stockholders' equity of $4 million, a $5 million MVPHS, and net income from continuing operations of at least $750,000 in the last fiscal year, or in two of the last three fiscal years.

To qualify an initial listing on the Nasdaq Global Market, an issuer must have at least 1.1 million publicly-held shares (excluding shares held by any officers, directors, or 10% shareholders), 400 round lot holders, three market makers and a minimum $4 bid price. Additionally, the issuer must meet one of the following three financial standards:

- stockholders' equity of $15 million, income of $1 million from continuing operations before income taxes in the latest fiscal year or in two of the last three fiscal years, three market makers, and an $8 million MVPHS;
- stockholders' equity of $30 million, an $18 million MVPHS, three market makers, and an operating history of two years; or
- a $75 million market value of listed securities or $75 million in total assets and $75 million in total revenue, a $20 million MVPHS, and four market makers.

To qualify for an initial listing on Nasdaq Global Select Market, an issuer that is neither a seasoned issuer[207] nor an affiliated issuer,[208] must have $45 million MVPHS and either 450 round lot holders or 2,200 total shareholders.

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[205] *Supra* note 202.

[206] A "round lot" means 100 shares.

[207] Nasdaq considers an issuer to be a "seasoned issuer" if it is already listed or quoted on another marketplace.

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To qualify for an initial listing on Nasdaq Global Select Market, seasoned issuers with currently trading common stock or other equivalents must have:

- either 450 round lot beneficial shareholders, 2,200 beneficial shareholders, or 550 beneficial shareholders and an average monthly trading volume of $1.1 million over the past twelve months; and

- a $110 million MVPHS, or a $100 million MVPHS and $110 million in shareholders' equity.

To qualify for an initial listing on Nasdaq Global Select Market, affiliated issuers must meet the same criteria as seasoned issuers but are only required to have $45 million MVPHS.

Whichever of these standards applies, an issuer listing on the Nasdaq Global Select Market is also required to have a minimum $4 bid price, a minimum of 1,250,000 publicly held shares, excluding shares held directly by officers, directors or any person who is the beneficial owner of more than 10% of the total shares outstanding and at least three market makers. An electronic communications network is not considered a market maker for this purpose.

To qualify for the Nasdaq Global Select Market, new issuers must meet one of the following three financial standards:

- aggregate pre-tax earnings of at least $11 million over the prior three years, with positive pre-tax earnings in each such year and at least $2.2 million of pre-tax earnings in each of the prior two years;

- aggregate cash flow of at least $27.5 million over the prior three years, with positive cash flow in each such year, an average market capitalization of at least $550 million over the prior twelve months and total revenue of at least $110 million in the previous fiscal year; or

- total revenue of at least $90 million in the previous year and an average market capitalization of at least $850 million over the prior twelve months.

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[208] Nasdaq considers an issuer to be an "affiliated issuer" if it is affiliated with another company listed on the Nasdaq Global Select Market, if such other company, directly or indirectly though one or more intermediaries, controls, is controlled by, or is under common control with, the issuer. For this purpose, control means having the ability to exercise significant influence, which is presumed to exist where the parent or affiliated company directly or indirectly owns 20% or more of the issuer's voting securities, and also can be indicated by representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel or technological dependency.

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Nasdaq Disclosure Requirements. An issuer must promptly disclose any material news through any Regulation FD compliant method (or combination of methods).[209] Material news is defined as information that would reasonably be expected to affect the value of its securities or influence investors' decisions. Material news may include the following categories:

- Financial-related disclosures, including quarterly or yearly earnings, earnings restatements, pre-announcements or "guidance";
- Corporate reorganizations and acquisitions, including mergers, tender offers, asset transactions and bankruptcies or receiverships;
- New products or discoveries, or developments regarding customers or suppliers (*e.g.*, significant developments in clinical or customer trials and receipt or cancellation of a material contract or order);
- Senior management changes or changes in control;
- Resignation or termination of independent auditors or withdrawal of a previously issued audit report;
- Events regarding the issuer's securities (*e.g.*, defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of securityholders or public or private sales of additional securities);
- Significant legal or regulatory developments; and
- Any event requiring the filing of a Form 8-K.

The issuer must also notify Nasdaq MarketWatch prior to the release of such information in order to permit MarketWatch to assess the news announcement for materiality and, in certain circumstances, implement temporary trading halts to allow for even dissemination of the material news. Issuers can disclose material news to MarketWatch through the Electronic Disclosure submission system.[210] Nasdaq no longer accepts material news disclosures by fax or telephone except in emergency situations. Notification should be provided at least ten minutes before the release of the information to the public.

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[209] These methods include broadly disseminating a press release, furnishing or filing a Form 8-K with the SEC, and conference calls, press conferences and webcasts so long as the public is provided adequate notice (generally through a press release) and granted access. See also SEC Release No. 34-58288 (Aug. 1, 2008) (http://www.sec.gov/rules/interp/2008/34-58288.pdf) for further guidance as to disclosure dissemination.

[210] The MarketWatch Electronic Disclosure submission system is available through http://www.nasdaq.net.

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Issuers are also required to notify Nasdaq when taking certain actions. Issuer actions requiring notification include the following:

- Listing of additional shares;
- Forward stock splits, stock dividends and rights offerings;
- Reverse stock splits;
- Cash dividend and distribution notices;
- Change in the number of shares outstanding of 5% or more;
- Change in the issuer name;
- Change in the trading symbol;
- Change in title of a security or par value;
- Change in transfer agent or registrar;
- Reclassification, exchange or other substitution of previously-listed class of securities;
- Change in state of incorporation or issuer place of organization;
- Mergers, tender offers, and redemptions/extensions of derivative securities; and
- Material non-compliance with Nasdaq corporate governance rules.

In most cases, issuers must fill out the appropriate notification form and may be required to provide additional supporting documentation.

Nasdaq Periodic Reporting Requirements. Nasdaq-listed companies are required to file with Nasdaq two copies of all reports and other documents filed or required to be filed with the SEC. Filing through the SEC's EDGAR system fulfills this requirement.

Nasdaq Corporate Governance Requirements. Nasdaq has established policies and requirements concerning certain corporate governance practices, such as the structure and composition of the board of directors, shareholder approval and related requirements.

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The Nasdaq corporate governance requirements, which are available on Nasdaq's website (the "Nasdaq Corporate Governance Rules"),[211] provide (subject to exceptions[212]), among other things, that:

- the issuer must have a majority of independent directors;[213]
- director nominees must either be selected, or recommended for the board's selection, by either a nominations committee comprised solely of independent directors or by a majority of the independent directors;[214,215]
- the independent directors must have regularly scheduled meetings at which only independent directors are present;
- compensation of the chief executive officer and all other executive officers must be determined, or recommended to the board for determination, either by a

[211] See Nasdaq Corporate Governance Rules.

[212] Nasdaq makes exceptions from these corporate governance rules for certain issuers, including controlled companies (companies where more than 50% of the voting power is held by an individual, a group or another company), limited partnerships, companies in bankruptcy, closed-end and open-end funds, certain passive business organizations in the form of trusts and foreign private issuers, as well as for derivatives and special purpose securities. Each of these types of issuers and securities is exempt from certain of the corporate governance rules.

[213] An issuer listing in conjunction with its initial public offering is required to meet the majority independent board requirements within 12 months of listing and is permitted to phase in its independent audit committee and, if it elects to have a nominations committee and compensation committee (rather than having the functions of those committees discharged by a majority of the independent directors), its independent nominations and compensation committees on the following schedule: one independent member of each committee at the time of listing, a majority of independent members of each committee within ninety days of listing and fully independent committees within one year of listing. Nasdaq will also permit issuers that are emerging from bankruptcy or have ceased to be controlled companies (as defined below) to phase in independent nominations and compensation committees (but not audit committees) and majority independent boards on the same schedule as issuers listing in conjunction with an initial public offering. An issuer of which more than 50% of the voting power is held by an individual, a group or another company (a "controlled company"), a limited partnership and any company in bankruptcy need not have a majority of independent directors on its board and, if it elects to have a nominations or compensation committee, need not have those committees composed solely of independent directors. However, all such controlled companies, limited partnerships and companies in bankruptcy must have an audit committee that has at least three members, satisfies the independence requirements of Rule 10A-3 under the 1934 Act, and consists solely of independent directors who have the requisite financial experience and expertise.

[214] Issuers listing on the Nasdaq may choose not to have a compensation or nominations committee and may instead rely upon a majority of the independent directors to discharge the responsibilities of these committees.

[215] *Supra* note 213.

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compensation committee comprised solely of independent directors or by a majority of the independent directors;[216]

- the issuer must have an audit committee that has at least three members, satisfies the independence requirements of Rule 10A-3 under the 1934 Act, and consists solely of independent directors who have the requisite financial experience and expertise;

- the audit committee or another independent body of the board of directors of issuers that are not limited partnerships shall conduct appropriate review and oversight of all related party transactions for potential conflicts of interest situations on an ongoing basis;

- approval of shareholders is required with respect to equity compensation plans and material revisions thereto, with certain limited exemptions;

- the issuer must provide Nasdaq with prompt notification after an executive officer becomes aware of any material non-compliance by the issuer with the Nasdaq Corporate Governance Rules;

- the issuer must adopt and make publicly available a code of conduct and ethics, applicable to all directors, officers and employees, which complies with the definition of a "code of ethics" as set forth in Item 406 of Regulation S-K; and

- the issuer must notify Nasdaq of the receipt of a going concern opinion from an auditor under Nasdaq Corporate Governance Rule 5250(b)(2).

For the purposes of the Nasdaq Corporate Governance Rules, an independent director means a person other than an executive officer or employee of the issuer or any other individual having a relationship which, in the opinion of the issuer's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. Furthermore, the following persons may not be considered as independent:

- a director who is, or during the past three years was, employed by the issuer;

- a director who accepted or has an immediate family member who accepted compensation from the issuer in excess of $120,000 during any twelve-month period within the last three years, other than (i) compensation for board or board committee service, (ii) compensation to an immediate family member who is an employee (other than an executive officer) of the issuer, or (iii) benefits under a tax-qualified retirement plan, or non-discretionary compensation;

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216 *Supra* note 213; *supra* note 214.

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- a director who is an immediate family member of an individual who is, or at any time during the past three years was, employed by the issuer as an executive officer;

- a director who is, or has an immediate family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the issuer made, or from which the issuer received, payments for property or services (other than those arising solely from investments in the issuer's securities or payments under non-discretionary charitable contribution matching programs) that exceed the greater of (i) 5% of the organization's consolidated gross revenues for that year or (ii) $200,000 in any of the most recent three fiscal years;

- a director who is, or has an immediate family member who is, employed as an executive officer of another entity where at any time during the past three fiscal years any of the issuer's executive officers served on the compensation committee of such other entity; or

- a director who is, or has an immediate family member who is, a current partner of the issuer's outside auditor, or was a partner or employee of the issuer's outside auditor who worked on the issuer's audit at any time during any of the past three years.

A director who is not independent under Nasdaq's definition may still be appointed to the nominations, compensation and audit committees for no longer than two years, if the board of the issuer determines, under exceptional and limited circumstances, that such director's membership on the committee is required by the best interests of the issuer and its shareholders (and such director is not a current officer or employee or an immediate family member of such officer or employee), and the issuer discloses, in the proxy statement for its next shareholders' meeting, the nature of the relationship and the reason for the determination.

All issuers are required to comply with the audit committee requirements of Rule 10A-3 under the 1934 Act, under which an issuer must have an audit committee comprised solely of directors who are independent and directly responsible for the issuer's relationship with an outside auditor. Furthermore, the committee is required, among other things, to have procedures for handling account-related complaints.

Nasdaq Shareholder Approval Requirements. Nasdaq requires shareholder approval for:

- the adoption of equity compensation plans and material revisions thereto, with limited exceptions;

- issuance of securities resulting in a change of control;

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- acquisitions where the issuance of securities equals 20% or more of the pre-transaction outstanding shares, or 5% or more of the pre-transaction outstanding shares when a related party has a 5% or greater interest in the acquisition target; or

- private placements where the issuance (together with sales by officers, directors, or substantial shareholders, if any) equals 20% or more of the pre-transaction outstanding shares at a price less than the greater of book or market value.

Nasdaq Continuing Listing Standards

On the Nasdaq Capital Market, issuers must maintain at least 500,000 publicly-held shares,[217] a $1 million MVPHS, a $1 bid price, at least 300 public holders, two market makers and at least one of the following: (i) $2.5 million in shareholders' equity, (ii) a market value of $35 million for listed securities (securities listed on Nasdaq or other national securities exchanges), or (iii) $500,000 of net income from continuing operations in the last fiscal year, or in two of the last three fiscal years.

There are two standards by which issuers can continue to list on the Nasdaq Global Market and the Nasdaq Global Select Market. Under the first standard, issuers must have $10 million in shareholders' equity, 750,000 publicly-held shares, a $5 million MVPHS and two market makers. Under the second standard, issuers must have 1.1 million publicly-held shares, a $15 million MVPHS, four market makers and either (i) a market value of $50 million for listed securities (securities listed on Nasdaq or other national securities exchanges) or (ii) total assets and total revenue of $50 million each for the most recently completed fiscal year or two of the three most recently completed fiscal years. Under both standards, issuers must have a minimum bid price of $1 per share and at least 400 total shareholders.

Nasdaq will delist an issuer in certain circumstances, following Nasdaq's determination that the issuer no longer meets the requirements for continued listing, and after the issuer has received notice of that determination and has had an opportunity to appeal. Nasdaq will provide public notice of its final determination to remove a security from listing by issuing a press release and posting notice on its web site. This public notice will be disseminated no fewer than ten days before the delisting becomes effective and will remain posted until the delisting is effective. Following such public notification, Nasdaq will file an application on Form 25 with the SEC to delist the security, and will promptly provide a copy of that Form 25 to the issuer. The Form 25, and the delisting of the security, will become effective ten days after it is filed, unless the SEC chooses to postpone such delisting. An issuer of a security the listing of which has been suspended is required, prior to re-listing, to comply with all requirements for continued listing. An issuer of a security the listing of

[217] Nasdaq defines publicly-held shares as shares not held directly or indirectly by an officer, director or any person who is the beneficial owner of more than 10% of the total shares outstanding.

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which has been terminated is required, prior to re-listing, to comply with the requirements for initial listing.

LISTING CERTAIN SECURITIES OTHER THAN EQUITY SECURITIES

An issuer may also wish to list other types of its securities on an exchange in the United States. The following summarizes the requirements of the NYSE, the NYSE Arca and the NYSE MKT to the listing of certain such securities.

Listing Debt Securities on the NYSE[218]

In order for debt securities to be listed on the NYSE, the debt securities must have an aggregate market value or principal amount of no less than $5 million. Debt securities that are convertible into equity securities may be listed only if (a) the underlying equity securities are subject to real-time last sale reporting in the United States and (b) the convertible debt securities have an aggregate market value or principal amount of no less than $10 million.

In addition, the NYSE will require that one of the following conditions be satisfied:

- the issuer of the debt securities has equity securities listed on the NYSE;
- an issuer of equity securities listed on the NYSE directly or indirectly owns a majority interest in, or is under common control with, the issuer of the debt securities;
- an issuer of equity securities listed on the NYSE has guaranteed the debt securities;
- a national statistical rating organization (an "NRSRO") has assigned a current rating to the debt securities that is no lower than a "B" rating by Standard & Poor's or an equivalent rating by another NRSRO; or
- if no NRSRO has assigned a rating to the issue, an NRSRO has currently assigned an investment grade rating to a senior issue or a rating that is no lower than a "B" rating by Standard & Poor's, or an equivalent rating by another NRSRO, to a *pari passu* or junior issue.

Listing Debt Securities on the NYSE Arca[219]

In order for debt securities to be listed on the NYSE Arca, the issuer must (i) have a net worth of at least $4 million, (ii) have pre-tax income from continuing operations of at

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[218] See Listing Debt Securities on the NYSE.

[219] See Listing Debt Securities on the NYSE Arca.

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least $750,000 in the last fiscal year or two of the last three fiscal years and (iii) meet and appear to be able to pay interest and principal when due on the debt securities to be listed.

In addition, the NYSE Arca requires that the following public distribution requirement be satisfied:

- if the issuer's common stock is traded on the NYSE Arca, the NYSE or the NYSE MKT, the debt securities to be listed must have an aggregate market value and principal amount of at least $5 million each, and at least 100 public beneficial holders; and

- if the issuer's common stock is not traded on any of the above referenced exchanges, the debt securities to be listed must have an aggregate market value and principal amount of at least $20 million, and at least 100 public beneficial holders; and

- in the case of municipal debt securities, debt securities to be listed must have an aggregate market value and principal amount of at least $20 million, at least 100 public beneficial holders, and be rated as investment grade by at least one NRSRO.

Debt securities that are convertible into equity securities may be listed on the NYSE Arca only if the underlying equity securities meet the NYSE Arca's criteria for continued listing and real-time last sale information with respect to the underlying equity securities is available.

Listing Equity-Linked Debt Securities on the NYSE[220]

Equity-Linked Debt Securities ("ELDS") are non-convertible debt securities of an issuer where the value of the debt security is based, at least in part, on the value of up to 30 common stocks, non-convertible preferred stocks, common units of master limited partnerships, or any other common equity securities of a type classified for trading as stock by the NYSE.

***Issuer Requirements*.** The NYSE requires that, (i) if the issuer of ELDS is a NYSE-listed company, the issuer be in good standing (*i.e.*, it meets the NYSE's criteria for continued listing); (ii) if the issuer is an affiliate of an NYSE-listed company, the NYSE-listed company be in good standing; and (iii) if the issuer is not listed or affiliated with an NYSE-listed company, the issuer meet the size and earnings requirements set forth in the NYSE listing standards.

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[220] See Listing Equity-Linked Debt Securities on the NYSE.

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The issuer must also have (1) a minimum tangible net worth of $250 million or (2) a minimum tangible net worth of $150 million, where the original issue price of the ELDS, combined with all of the issuer's other ELDS listed on a national securities exchange or otherwise publicly traded in the United States, is not greater than 25% of the issuer's net worth at the time of issuance.

ELDS Requirements. The ELDS to be listed must consist of at least one million ELDS outstanding and must have at least 400 public holders, an aggregate market value of $4 million, and a minimum life of one year.

Linked Equity Requirements. An equity security on which the value of the ELDS is based must:

- have a market capitalization and trading volume in the United States in the one-year period preceding the listing of the ELDS that meets one of the following requirements:
  - $3 billion in market capitalization and trading volume of 2.5 million shares;
  - $1.5 billion in market capitalization and trading volume of 10 million shares; or
  - $500 million in market capitalization and trading volume of 15 million shares;
- be issued by a 1934 Act reporting company that is listed on a national securities exchange and, if any underlying security to which the ELDS is to be linked is the stock of a non-U.S. company that is traded in the U.S. market as American depositary shares or American depositary receipts (in either case, "ADSs"), ordinary shares or otherwise, then for each such security, one of the following conditions must be met:
  - the NYSE has in place with the primary exchange on which each non-U.S. security is traded (or in the case of a sponsored ADS, the NYSE has in place with the primary exchange in the country where the security underlying the ADS is primarily traded) an effective, comprehensive surveillance information sharing agreement; or
  - the "Relative U.S. Volume"[221] is at least 50%; or
  - during the preceding six months:

[221] "Relative U.S. Volume" is the ratio of (i) the combined trading volume, on a share-equivalent basis, of the security and related securities (including ADSs overlying such security) in the United States and in any other market with which the NYSE has in place an effective, comprehensive surveillance information sharing agreement to (ii) the worldwide trading volume in such securities.

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— the combined trading volume of the security and "related securities," consisting of other classes of common stock related to the security (including ADSs overlying such other classes, on a share equivalent basis), in the U.S. market is at least 20% of the combined worldwide trading volume in the security and in related securities;

— the average daily trading volume for the security (or, if traded in the form of an ADS, the ADS overlying such security) in the U.S. market is 100,000 or more shares; and

— the trading volume for the security (or, if traded in the form of an ADS, the ADS overlying such security) is at least 60,000 shares per day in the U.S. market on a majority of the trading days during the six-month period.

Limits on Number of ELDS. Without NYSE and SEC approval, the issuance of ELDS relating to any underlying U.S. security may not exceed 5% of the total outstanding shares of such underlying security.

Without NYSE and SEC approval, the issuance of ELDS relating to any underlying non-U.S. security or ADS may not exceed:

- 2% of the total worldwide outstanding shares of such security if at least 20% of the worldwide trading volume in the security and related securities during the six-month period preceding the date of listing occurs in the U.S. market;
- 3% of the total worldwide outstanding shares of such security if at least 50% of the worldwide trading volume in the security and related securities during the six-month period preceding the date of listing occurs in the U.S. market; or
- 5% of the total worldwide outstanding shares of such security if at least 70% of the worldwide trading volume in the security and related securities during the six-month period preceding the date of listing occurs in the U.S. market.

If an issuer proposes to issue ELDS that relate to more than the allowable percentages of the underlying security specified above, then the NYSE, with the concurrence of the staff of the Division of Trading and Markets of the SEC, will evaluate the maximum percentage of ELDS that may be issued on a case-by-case basis. Historically, the Division of Trading and Markets has been reluctant to exceed the above-described limits.

In the case of ELDS, delisting will be considered if: (i) the number of publicly-held shares of the underlying security is fewer than 100,000; (ii) the number of holders of ELDS is fewer than 100; (iii) the aggregate market value of outstanding shares of the underlying security is less than $1 million; (iv) the issuer of the underlying security is no longer subject to reporting obligations under the 1934 Act; (v) the security to which the ELDS is linked no longer trades in a market in which there is last sale reporting; or (vi) the issuer is not able to meet its obligations on the ELDS.

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Listing Equity-Linked Term Notes (“ELTNs”) on the NYSE MKT and the NYSE Arca[222]

ELTNs are debt securities that are linked, in whole or in part, to the market performance of up to 30 common stocks or non-convertible preferred stocks. ELTNs will be considered for listing on the NYSE MKT or the NYSE Arca under the following conditions:

- both the ELTNs to be listed and issuer of such ELTNs meet certain numerical criteria relating to the assets and equity of the issuer, minimum level of distribution of the issuer’s securities, aggregate market value, and other matters;

- the ELTNs must have a minimum term of one year;

- the issuer of such ELTNs either (1) must have a minimum tangible net worth in excess of $250 million, and otherwise substantially exceed, in the case of the NYSE MKT, the earnings requirements under the NYSE MKT Initial Listing Standards or, in the case of the NYSE Arca, pre-tax income from continuing operations of at least $750,000 in its last fiscal year or in two of its last three fiscal years or (2) must (a) have a minimum tangible net worth of $150 million, and otherwise substantially exceed, in the case of the NYSE MKT, the earnings requirements under the NYSE MKT Initial Listing Standards or, in the case of the NYSE Arca, pre-tax income from continuing operations of at least $750,000 in its last fiscal year or in two of its last three fiscal years and (b) not have issued such ELTNs where the original issue price of all the issuer’s other equity-linked note offerings (combined with ELTN offerings of the issuer’s affiliates) listed on a national securities exchange exceeds 25% of the issuer’s net worth;

- each issuer of an underlying security to which the ELTNs are linked must be a reporting company under the 1934 Act that is listed on a national securities exchange and, in the case of the listing requirements of the NYSE MKT, must also be subject to last sale reporting;

- if any underlying security to which the ELTN is to be linked is the stock of a non-U.S. issuer that is traded in the U.S. market as sponsored ADSs,[223] ordinary shares or otherwise, then for each such security the NYSE MKT or the NYSE Arca, as

[222] See Listing ELTNs on the NYSE MKT for related rules of the NYSE MKT; see Listing ELTNs on the NYSE Arca for related rules for the NYSE Arca.

[223] The NYSE MKT Company Guide and the NYSE Arca Equities Rules both use “American Depositary Share” (or “ADS”) in the context of equity-linked term note listing requirements. The term “American Depositary Receipt” (or “ADR”) is used in the context of index-linked securities. Although market participants do not typically differentiate between an ADS and an ADR, the NYSE MKT listing standards and the NYSE Arca listing standards employ the terms in different contexts. See Johnson, Jr., Charles J. and Joseph McLaughlin, CORPORATE FINANCE AND THE SECURITIES LAWS, Section 9.03[B].

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the case may be, must either (A) have in place a comprehensive surveillance sharing agreement with the primary exchange on which each non-U.S. security is traded, (or in the case of an ADS, the primary exchange on which the security underlying the ADS is traded); (B) the combined trading volume of each non-U.S. security and other related non-U.S. securities occurring in the U.S. market or in markets with which the NYSE MKT or the NYSE Arca, as the case may be, has in place a comprehensive surveillance sharing agreement represents (on a share-equivalent basis for any ADSs) at least 50% of the combined worldwide trading volume in each non-U.S. security, other related non-U.S. securities, and other classes of common stock related to each non-U.S. security over the six-month period preceding the date of listing; or (C) (i) the combined trading volume of each non-U.S. security and other related non-U.S. securities occurring in the U.S. market represents (on a share-equivalent basis) at least 20% of the combined worldwide trading volume in each non-U.S. security and in other related non-U.S. securities over the six-month period preceding the date of selection of the non-U.S. security for listing, (ii) the average daily trading volume for each non-U.S. security in the U.S. markets over the six months preceding the selection of each non-U.S. security for listing is 100,000 or more shares and (iii) the trading volume is at least 60,000 shares per day in the U.S. markets on a majority of the trading days for the six months preceding the date of selection of each non-U.S. security for listing;

- the issuance of the ELTN may not exceed 5% of the total outstanding shares of each underlying linked stock to which it relates, provided however, if any non-U.S. security and related securities has less than 20% of the worldwide trading volume occurring in the U.S. market during the six-month period preceding the date of listing, then the ELTN may not be linked to that non-U.S. security. If any underlying linked stock is a non-U.S. security represented by ADSs, common shares, or otherwise, then for each such linked security the ELTN may not exceed: (A) 2% of the total shares outstanding worldwide provided at least 20% of the worldwide trading volume in each non-U.S. security and related non-U.S. security during the six-month period preceding the date of listing occurs in the U.S. market; (B) 3% of the total worldwide shares outstanding, provided at least 50% of the worldwide trading volume in each non-U.S. security and related non-U.S. security during the six-month period preceding the date of listing occurs in the U.S. market; and (C) 5% of the total shares outstanding worldwide, provided at least 70% of the worldwide trading volume in each non-U.S. security and related non-U.S. security during the six-month period preceding the date of listing occurs in the U.S. market;

- if any underlying security to which the ELTN is to be linked is the stock of a non-U.S. issuer which is traded in the U.S. market as a sponsored ADS, ordinary shares or otherwise, then the minimum number of holders of such underlying linked security must be 2,000;

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- in the case of the NYSE MKT, the underlying linked stock either (A) has a minimum market capitalization of $3 billion and during the twelve months preceding listing is shown to have traded at least 2.5 million shares, (B) has a minimum market capitalization of $1.5 billion and during the twelve months preceding listing is shown to have traded at least 10 million shares or (C) has a minimum market capitalization of $500 million and during the twelve months preceding listing is shown to have traded at least 15 million shares;

- in the case of the NYSE Arca, the underlying linked stock either (A) has a minimum market capitalization of $3 billion and trading volume in the United States of at least 2.5 million shares in the one-year period preceding listing, (B) has a minimum market capitalization of $1.5 billion and trading volume in the United States of at least 10 million shares in the one-year period preceding listing or (C) has a minimum market capitalization of $500 million and trading volume in the United States of at least 15 million shares in the one-year period preceding listing; and

- ELTNs will be listed as equity securities, and will be subject to margin rules applicable to equity securities.

If an issuer proposes to list an ELTN that relates to more than the allowable percentages in paragraph (f) above, the NYSE MKT or the NYSE Arca, as the case may be, with the concurrence of the staff of the Division of Market Regulation of the SEC, will evaluate the maximum percentage of ELTN that may be issued on a case-by-case basis. Historically, the Division of Trading and Markets has been reluctant to exceed the above-described limits.

Listing Preferred Stock on the NYSE and the NYSE Arca[224]

The NYSE has not set any minimum numerical criteria for the listing of preferred stock. The issue must be of sufficient size and distribution, however, to warrant trading in the NYSE system. The NYSE has set certain numerical delisting criteria for preferred stock. The NYSE will normally consider suspending or removing a preferred stock if the aggregate market value of publicly-held shares is less than $2 million and the number of publicly-held shares is fewer than 100,000.

In order for preferred stock to be listed on the NYSE Arca, the following requirements must be met:

- if the common stock or common stock equivalent security of the issuer is listed on the NYSE, NYSE Arca or the NYSE MKT, the preferred stock must have: (i) at

[224] See Listing Preferred Stock on the NYSE for related rules of the NYSE; see Listing Preferred Stock on the NYSE Arca for related rules of the NYSE Arca.

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least 100,000 publicly-held shares; (ii) an aggregate market value of publicly-held shares of at least $2 million; and (iii) a minimum closing price per share of $10; and

- if the issuer's common stock or common stock equivalent security is not listed on any of the above referenced exchanges, then the preferred stock must have (i) at least 400,000 publicly held shares; (ii) an aggregate market value of at least $4,000,000; (iii) a minimum closing bid price of $10; and (iv) at least 800 public beneficial holders of 100 shares or more.

In the case of an issuer whose common stock or common stock equivalent security is listed on the NYSE Arca, the Nasdaq Global Market or the NYSE MKT, the NYSE Arca will normally consider suspending or removing such issuer's preferred stock if the preferred stock has: (i) fewer than 100,000 publicly-held shares; (ii) a market value of publicly-held shares of less than $1 million; or (iii) fewer than 150 public beneficial holders. In the case of a non-listed issuer, the NYSE Arca will normally consider suspending or removing such issuer's preferred stock if the preferred stock does not meet the NYSE Arca's applicable continued listing criteria for the common stock of the issuer.

The NYSE Arca will not list convertible preferred stock containing a provision that permits the issuer, at its discretion, to change the conversion price other than in accordance with the terms of the issuer's articles of incorporation or any amendments thereof.

Voting Rights in the Event of Dividend Arrearages. With respect to the rights of holders of preferred stock in the event of missed dividends, the NYSE provides that such holders should have the right to elect a minimum of two directors upon default of the equivalent of six quarterly dividends. The right to elect directors accrues regardless of whether defaulted dividends occurred in consecutive periods and remains in effect until cumulative dividends have been paid in full or until non-cumulative dividends have been paid regularly for at least a year. The NYSE Arca provides that preferred stockholders may elect at least two members of the issuer's board of directors no later than two years after a default in the payment of fixed dividends.

Changes in Terms of Preferred Stock. With respect to a change in the terms of the preferred stock, the NYSE requires approval by the holders of at least two-thirds of the outstanding shares of a preferred stock in order for the adoption of any charter or by-law amendment that would materially affect existing terms of the preferred stock. If all series of a class of preferred stock are not equally affected by the proposed changes, the NYSE provides that there should be a two-thirds approval of the class and a two-thirds approval of the series that will have a diminished status. The NYSE Arca provides that the holders of at least two-thirds of the preferred class must approve any change in the rights, privileges, or preferences of the class before such change may go into effect. The NYSE Arca also provides that in order for the listing of an additional class of preferred stock senior or equal in preference to an existing preferred class, there must be a favorable majority vote of the existing preferred class voting as a class.

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Listing Preferred Stock on the NYSE MKT[225]

The listing of preferred issues on the NYSE MKT is considered on a case-by-case basis, in light of the suitability of the issue for continuous auction market trading. The NYSE MKT generally will not consider listing convertible preferred stock of an issuer unless current last sale information is available with respect to the underlying common stock into which the preferred stock is convertible. In the case of an issuer whose common stock is traded on the NYSE MKT or NYSE, such issuer should meet the size and earnings requirements described in the NYSE MKT Initial Listing Standards and should maintain a minimum of 100,000 publicly-held shares, an aggregate public market value of $2 million and a minimum price of $10 per share. A non-listed issuer must maintain 400,000 publicly-held preferred shares, at least 800 public round-lot shareholders, an aggregate public market value of $4 million and a minimum price of $10 per share.

The NYSE MKT will not list convertible stock containing a provision that gives the issuer the right, at its discretion, to reduce the conversion price for periods of time or from time to time unless the issuer establishes a minimum period of ten business days within which such price reduction will be in effect.

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[225] See Listing Preferred Stock on the NYSE MKT for related rules of the NYSE MKT.

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SECTION III. ONGOING COMPLIANCE OBLIGATIONS

An issuer that has registered securities under the 1933 Act or has securities listed on a U.S. securities exchange will be subject to the ongoing reporting and other requirements of the 1934 Act, Sarbanes-Oxley, Dodd-Frank and the Foreign Corrupt Practices Act, as discussed in Chapter 7 (*Ongoing Reporting and Other Requirements*). Many of these requirements need to be satisfied at the time of the offering and sale of securities in the U.S. capital markets or at the time of listing on a U.S. securities exchange, as well as on an ongoing basis. An issuer that has securities listed on a U.S. securities exchange has more ongoing obligations than an issuer that is subject to or has voluntarily subjected itself to the reporting requirements of the 1934 Act, but has no securities listed on a U.S. securities exchange. See Chapter 6 (*Listing on U.S. Securities Exchanges*).

Also, as mentioned in Chapter 1 (*The Offering Process*), it is important for issuers to consider the ongoing reporting and other requirements of the 1934 Act and other applicable U.S. laws at the time they are deciding between accessing the U.S. capital markets pursuant to a 1933 Act-registered offering or through an exempt transaction, such a Rule 144A offering, or by issuing exempt securities. While there are fewer ongoing requirements applicable to exempt offerings and offerings of exempt securities, some, such as the Federal Reserve Board's margin rules, are applicable to exempt offerings and offerings of exempt securities.

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CHAPTER 7

ONGOING REPORTING AND OTHER REQUIREMENTS

GENERAL 216
HOLDERS OF RECORD 217
PERIODIC REPORTING REQUIREMENTS 218
EXTENSIBLE BUSINESS REPORTING LANGUAGE (“XBRL”) 221
SARBANES-OXLEY 222
BENEFICIAL OWNERSHIP REPORTING UNDER SECTION 13 237
INSIDER TRADING AND SHORT SWING PROFIT RULES 238
PROXY RULES 238
COMMUNICATIONS WITH INVESTORS AND THE PUBLIC 239
FOREIGN CORRUPT PRACTICES ACT OF 1977 (“FCPA”) 251
THE OFFICE OF FOREIGN ASSETS CONTROL (“OFAC”) 253

GENERAL

An issuer becomes subject to the 1934 Act’s registration and reporting regime as a result of any of the following:

- listing a class of either equity or debt securities on a U.S. securities exchange under Section 12(b) of the 1934 Act;

- registering a class of equity securities under Section 12(g) of the 1934 Act either voluntarily or (i) because it has $10 million in total assets and either (a) 2,000 or more security holders of record or (b) 500 or more security holders of record that are not accredited investors or (ii) because it is a bank holding company, as defined under the BHCA, with total assets exceeding $10 million dollars and 2,000 or more security holders of record.

- registering either equity or debt securities under a 1933 Act registration statement, which has become effective, thus triggering 1934 Act reporting obligations under Section 15(d) of the 1934 Act, which generally require the issuer to file an annual report on Form 10-K for the fiscal year of the issuer in which the registration statement became effective and thereafter so long as the issuer has 300 holders of record or, in the case of a bank holding company, 1,200 holders of record.[226]

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[226] For these purposes, effectiveness of the registration statement triggers the obligation to file an annual report with respect to the fiscal year in which the registration statement was declared effective by the SEC.

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Once the securities are registered under either the 1933 Act or the 1934 Act, the issuer's reporting obligations continue, and it remains subject to the other provisions of the 1934 Act and the SEC's rules thereunder, until it de-registers, as discussed in Chapter 17 (*De-Registering Under the 1934 Act*). As a general matter, it is the issuer's responsibility to terminate its 1934 Act registration obligations with respect to a class of securities and, failing to do so, it will continue to be subject to the ongoing compliance and other requirements that are discussed in this chapter.

While there are generally fewer ongoing requirements applicable to exempt offerings and offerings of exempt securities (and some of the requirements are the result of the requirements of the applicable exemption, as described in Chapter 8 (*Exempt Offerings and Securities*)), some obligations described in this chapter, such as those under the FCPA and the rules administered by OFAC, may also be applicable to exempt offerings and offerings of exempt securities.

HOLDERS OF RECORD

As indicated above, the 1934 Act's reporting requirements are based upon an issuer's equity holders of record. Rule 12g5-1 under the 1934 Act provides that securities shall be deemed to be "held of record" by each person who is identified on the records maintained by or on behalf of the issuer as the owner of the securities with the following qualifications:

- securities identified as held of record by a corporation, a partnership, a trust or other organization shall be counted as held of record by one person;
- securities identified as held of record by one or more persons acting as trustees, executors, guardians, custodians or in other fiduciary capacities with respect to a single trust, estate or account shall be counted as held of record by one person;
- securities held by two or more persons as co-owners shall be counted as held by one person;
- each outstanding unregistered or bearer certificate shall be counted as held of record by a separate person, except to the extent that the issuer can establish that, if such securities were registered, they would be held of record in accordance with the provisions of this rule by a lesser number;
- securities registered in substantially similar names shall be counted as held by one person if the issuer has reason to believe because of the address or other indicators that such names represent the same person; and
- if the issuer's records of securityholders have not been maintained in accordance with accepted practice, each additional person who would be identified as an owner on those records had such records been kept in accordance with accepted practice must be counted as a holder of record.

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The qualifications above are subject to the following three provisions:

(1) if the issuer knows that securities are held subject to a voting trust, deposit agreement or similar arrangement, the number of record holders of interests in that arrangement shall be included as the number of record holders of those securities (for these purposes, the issuer may rely in good faith on the information it receives from a non-affiliated issuer of the interests in such an arrangement);

(2) where the issuer is a savings and loan association, building and loan association, cooperative bank, homestead association or similar institution, securities, whole or fractional, issued for the sole purpose of qualifying a borrower for membership in the issuer, and which are to be redeemed or repurchased by the issuer when the borrower's loan is terminated, shall not be included as held of record by any person; and

(3) if the issuer knows or has reason to know that the form through which securities of record are held is used primarily to circumvent the registration and reporting provisions of the 1934 Act, the beneficial owners of such securities shall be deemed to be the record owners thereof.[227]

PERIODIC REPORTING REQUIREMENTS

Periodic SEC Reporting

An issuer that has a class of securities registered under the 1934 Act or has had a 1933 Act registration statement become effective is required to file periodic disclosure reports under the 1934 Act with the SEC until it terminates its obligations as described in Chapter 17 (*De-Registering Under the 1934 Act*). The periodic disclosure requirements established by the SEC are designed to ensure that the issuer makes available to holders of, and prospective investors in, its securities reasonably current information about itself, its business, its financial results and condition and any other matter that might be material to holders and prospective investors.

For U.S. issuers, the applicable periodic disclosure forms are Form 10-K for annual reports, Form 10-Q for quarterly reports and Form 8-K for reports of material matters not disclosed in an issuer's most recent Form 10-K or Form 10-Q. The SEC's 1934 Act filing requirements for U.S. issuers are as follows:

[227] For further information regarding the determination of holders of record for purposes of de-registering under the 1934 Act, see the discussion under the heading "Holders of Record" in Chapter 17 (*De-Registering Under the 1934 Act*).

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- Form 10-K must be filed within sixty days after the end of the fiscal year covered by the report for large accelerated filers, within seventy-five days after the fiscal year end for accelerated filers and within ninety days after the fiscal year end for all other registrants;

- Form 10-Q must be filed within forty days after the end of the fiscal quarter covered by the report for large accelerated filers and accelerated filers and within forty-five days after the end of the fiscal quarter covered for all other registrants; and

- Form 8-K generally must be filed within four business days of the occurrence of the event that triggers the filing obligation. Special rules apply to timing requirements for filings required by Regulation FD, as discussed below under the heading "Communications with Investors and the Public–Regulation FD." Information furnished pursuant to the requirement of Item 2.02 of Form 8-K (Results of Operations and Financial Condition) or Item 7.01 (Regulation FD Disclosure) is not deemed filed for 1934 Act Section 18 liability purposes (*i.e.*, in determining whether the information contains any material misstatements or omits any material information) unless the issuer specifically states that the information is to be considered "filed" under the 1934 Act or incorporates it by reference into a filing under the 1933 Act or 1934 Act.

The disclosure requirements for annual reports on Forms 10-K, quarterly reports on Form 10-Q, periodic reports on Form 8-K and annual proxy statements are discussed in Chapter 4 (*Disclosure Requirements*). See also Appendix F – *Form 8-K Disclosure Requirements Chart*.

U.S. Securities Exchange Reporting

While an issuer has securities listed on a U.S. securities exchange,[228] it must periodically file certain reports and other information with the applicable exchange.

The requirements of the NYSE, NASDAQ and the NYSE MKT are similar. The NYSE, for example, requires a listed issuer to agree to provide the exchange with, among other things:

(1) prompt notification of such events as a change in the general character or nature of the issuer's business, any changes in the issuer's officers or directors, any changes in the form or nature of the issuer's listed securities, any removal of, or change in, collateral underlying the listed securities, changes in the conversion rate of a listed convertible security, decrease in the supply of listed stock

[228] See Chapter 6 (*Listing on U.S. Securities Exchanges*) for more information about the ongoing requirements of U.S. securities exchanges.

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available for the market, any material disposition of assets, any dividend or stock distribution action, the payment of (or failure to pay) contingent interest or the failure to pay interest when due, redemption of the issuer's listed securities, any action granting shareholders the right to subscribe for new or additional securities, any changes in treasury stock, or any change in accountants;

(2) copies of proxy materials filed with the SEC;

(3) copies of amendments to the issuer's certificate of incorporation or bylaws;

(4) prompt notification of closing of transfer books or record dates;

(5) prior notification of certain events, such as any changes in the rights and nature of the issuer's listed securities, any changes to the issuer's name, any appointment of a new transfer agent, registrar, trustee or fiscal agent, and substantial charges to be made against capital surplus; and

(6) on demand, such information concerning the issuer as the NYSE may reasonably require.

Proxy Statements

All proxy solicitations by U.S. issuers with respect to equity securities registered under the 1934 Act will be subject to the SEC proxy rules and, with limited exceptions, no proxy solicitations may be made unless each person solicited is concurrently furnished or has been previously furnished with a publicly-filed preliminary or definitive written proxy statement containing the information specified in Schedule 14A. The purpose of the proxy rules is to prevent management and others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitations. Accordingly, the rules specify certain information that must be provided in connection with any proxy solicitation by the issuer. These rules also cover the form of proxy card sent to stockholders. The disclosure requirements for proxy statements are discussed under the heading "Disclosure Requirements of Proxy Statements" in Chapter 4 (*Disclosure Requirements*). The proxy rules are discussed in more detail later in this chapter, see "Proxy Rules" below.

Reports to Shareholders

Rule 14a-3(b) under the 1934 Act requires a proxy solicitation on behalf of the issuer with respect to an annual meeting for the election of directors to be accompanied or preceded by an annual report. The annual report disclosure requirements substantially overlap with the requirements of the annual report on Form 10-K discussed in Chapter 4 (*Disclosure Requirements*) and many companies satisfy their obligations to provide an annual report by providing a copy of the Form 10-K, either as filed or "wrapped" with additional pages. When this is not the case, the annual report to shareholders must contain an undertaking from

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the issuer to provide without charge to each person solicited a complete copy of its annual report on Form 10-K.

Seven copies of the annual report to shareholders must be mailed to the SEC, solely for its information, not later than the date on which such report is first sent or given to security holders or the date on which the solicitation material is filed with the SEC.

EXTENSIBLE BUSINESS REPORTING LANGUAGE ("XBRL")

XBRL is an interactive data technology that uses unique tags to identify individual items in an issuer's financial statements so they are more searchable and more readable by spreadsheets and other comparative and analytical tools used by investors and financial analysts. These tags generally allow investors to identify more readily specific financial data in SEC filings and compare it with similar data for other companies. In January 2009, the SEC adopted rules to phase in mandatory XBRL reporting.[229] All filers using either U.S. GAAP or IFRS are required to provide XBRL reports. For a U.S. issuer, the first filing subject to the XBRL filing requirement will be a quarterly report on Form 10-Q rather than an annual report on Form 10-K. Interactive financial data is required to be filed as an exhibit to any 1933 Act registration statement, other than an issuer's initial public offering, that includes financial statements in the filing (as opposed to incorporating them by reference), any Forms 10-K or Forms 10-Q and any Forms 8-K that include updated or revised financial statements. The interactive data will also need to be posted on the issuer's web site on the earlier of the calendar day such data was filed or the date the issuer was required to file the related registration statement or report and retained for a period of twelve months.

Financial statement footnotes and schedules must will be tagged individually as a block of text for one year, after which time the issuer will be required to tag the detailed quantitative disclosures within the footnotes and schedules. The issuer will also be permitted to tag each narrative disclosure if it so chooses.

Issuers that do not provide or post the required interactive data will be deemed not current with their 1934 Act reporting requirements and, as a result, will not be eligible to use Forms S-3, S-8, and, to the extent that it incorporates information by reference, S-4. Similarly, an issuer will not be deemed to have available adequate current public information for purposes of Rule 144 if it does not provide or post the required interactive data. However, an issuer that is deemed not current with its 1934 Act reporting requirements solely as a result of not providing or posting the interactive data exhibit when required will be deemed current upon providing or posting the interactive data. As such, it will not lose its

[229] See SEC Release No. 33-9002 (Jan. 30, 2009) (http://www.sec.gov/rules/final/2009/33-9002.pdf). For further discussion of these rules, see Sidley Austin LLP Securities Update "*New SEC Rules to Require Financial Statements in Interactive Format*" (http://www.sidley.com/64/newsinsights/newsdetail.aspx?news=4010).

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status as having "timely" filed its 1934 Act reports or its eligibility to use Form S-3 solely as a result of the delay in providing interactive data.

Prior to the date twenty-four months from the date an issuer is first required to file interactive data files (but no later than October 31, 2014), such files will be treated in a modified manner for certain liability purposes. During this time, such files will not be subject to certain liability provisions under U.S. federal securities laws (including Sections 11 and 12 of the 1933 Act), and, with respect to the anti-fraud provisions of the 1934 Act, will be protected from liability for any failure to comply with the tagging requirements if the interactive data file failed to meet those requirements (despite the issuer's good faith effort) and the issuer corrected the failure promptly after becoming aware of it.

These rules do not alter the requirements to provide financial statements and any required financial statement schedules with the traditional format filings.

SARBANES-OXLEY

Sarbanes-Oxley and the related rules adopted by the SEC require certain corporate governance practices and prescribe certain disclosures for public companies in the U.S. markets. Sarbanes-Oxley places responsibilities on principal executive officers, principal financial officers, audit committees and lawyers who are involved in the disclosure process. Sarbanes-Oxley also strengthens the regulation of accounting firms that perform audit and review services for public companies and emphasizes the independence standards for accounting firms.

In enacting Sarbanes-Oxley, Congress intended to bring about increased transparency in the U.S. capital markets and to improve the information available to investors.

Sarbanes-Oxley applies to "issuers," as that term is defined in Section 2(a)(7) of Sarbanes-Oxley. That term includes issuers that have securities registered under Section 12 of the 1934 Act, are required to file reports under Section 15(d) of the 1934 Act or are conducting an IPO of equity or debt securities and have filed a registration statement with the SEC under the 1933 Act in respect of the IPO that has not yet become effective (and which registration statement has not been withdrawn).[230]

Sarbanes-Oxley does not apply to issuers that are exempt from SEC reporting requirements, such as those who sell their securities in the United States pursuant to Rule 144A under the 1933 Act.

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[230] Most of the provisions of Sarbanes-Oxley do not apply to issuers who voluntarily file reports under Section 15(d) of the 1934 Act. See Question 1 of the Division of Corporation Finance: Sarbanes-Oxley Act of 2002 – Frequently Asked Questions (http://www.sec.gov/divisions/corpfin/faqs/soxact2002.htm). However, the CEO/CFO certification requirements, criminal provisions and employee whistleblower protections, among other provisions, do apply to such issuers. Voluntary filers should consult their U.S. counsel with respect to applicable Sarbanes-Oxley requirements.

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Disclosure and Related Requirements

The disclosure and related requirements of Sarbanes-Oxley are discussed below and in the discussion of the related items of Form 10-K under the heading "Disclosure Requirements for "S" Forms–Disclosure Requirements of Form 10-K" in Chapter 4 (*Disclosure Requirements*).

Disclosure Certification, Controls and Procedures[231]

Under Sarbanes-Oxley Sections 302 and 906, an issuer's chief executive officer and chief financial officer must personally certify as to the accuracy of disclosure and the fair presentation of financial information contained in quarterly reports on Form 10-Q and annual reports on Form 10-K filed with the SEC. In this regard, issuers should note:

- current reports on Form 8-K are not covered by the certification requirement;
- the chief executive officer and chief financial officer certifications called for by Sections 302 and 906 of Sarbanes-Oxley must be filed as exhibits to annual reports on Form 10-K and quarterly reports on Form 10-Q; and
- there are severe penalties for those that "knowingly" (a maximum of $l million/ten years in prison) or "willfully" (a maximum of $5 million/twenty years in prison) make a false Sarbanes-Oxley Section 906 certification.[232]

The forms of the required certifications are detailed and discussed under the heading "Signatures and Certifications" in Chapter 4 (*Disclosure Requirements*).

The Section 302 certification must be in the exact form specified by Item 601(31) of Regulation S-K, and includes, among other assurances, statements that the officer has reviewed the report and finds no untrue statement of material fact, has designed and maintains disclosure controls and procedures and internal control over financial reporting for the issuer, and has revealed to the issuer's audit committee and auditors all significant deficiencies and material weaknesses in internal control over financial reporting, and has reported to the audit committee any fraud, whether material or not, involving persons having a significant role in the issuer's internal control over financial reporting. With respect to

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[231] See Sarbanes-Oxley Sections 302 and 906; Rules 13a-14, 13a-15, 15d-14 and 15d-15 under the 1934 Act.

[232] The SEC stated in Release No. 33-8124 that a false Section 302 certification could give rise to liability consequences under Sections 13(a) or 15(d) of the 1934 Act, as well as Sections 11 and 12(a)(2) of the 1933 Act in cases where an annual report on Form 10-K is incorporated by reference into a registration statement on Form S-3 or into a prospectus filed pursuant to Rule 424(b) under the 1933 Act. Furthermore, SEC and private rights of action may arise under Section 10 and Rule 10b-5 under the 1934 Act. See SEC Release No. 33-8124 (Aug. 28, 2002) (http://www.sec.gov/rules/final/33-8124.htm). For a further discussion of liability under Sarbanes-Oxley and other U.S. securities laws, see Chapter 16 (*Liabilities Under U.S. Securities Laws*).

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internal controls, the certification states that (1) the report discloses any change in the issuer's internal control over financial reporting that occurred in the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting; (2) the CEO and the CFO have disclosed to the audit committee (A) all significant deficiencies and material weaknesses in the design or operation of the issuer's internal control over financial reporting which are reasonably likely to adversely affect the issuer's ability to record, process, summarize and report financial information and (B) any fraud, whether or not material, involving persons playing a significant role in the issuer's internal control over financial; (3) the CEO and the CFO are responsible for establishing and maintaining the issuer's internal control over financial reporting; and (4) the CEO and the CFO have designed the issuer's internal control over financial reporting, or caused it to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and preparation of the issuer's financial statements for external purposes in accordance with U.S. GAAP. The certifications as to internal control over financial reporting in clauses (3) and (4) above may be omitted from the Section 302 certifications until the issuer becomes subject to the SEC's rules promulgated pursuant to Sarbanes-Oxley Section 404 relating to internal control over financial reporting which, among other things, require a report from management with respect to the issuer's internal control over financial reporting.

In the Section 906 certification, the certifying officer must certify two items: (1) that the relevant periodic report fully complies with the requirements of Section 13(a) or 15(d) of the 1934 Act; and (2) that the information contained therein fairly presents, in all material respects, the financial condition and results of operation of the issuer.

An issuer must maintain disclosure controls and procedures designed to enable the issuer to report required disclosure in a timely fashion. Management must supervise, participate in and report on an annual evaluation of these controls and procedures on Forms 10-K and 10-Q.[233]

Internal Control Reports in Annual Reports[234]

Section 404 of Sarbanes-Oxley directed the SEC to adopt rules that require each annual report of a reporting company under the 1934 Act to contain (i) an internal control report by management stating its responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting, including an assessment, as of the end of the issuer's most recent fiscal year, of the effectiveness of the issuer's internal

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[233] While not required either by Sarbanes-Oxley or the SEC's rules thereunder, many issuers have formed a "disclosure committee" of management with detailed responsibilities for both an overall assessment of an issuer's reporting process and a review thereafter of specified SEC filings. The SEC suggested the need for such a committee in connection with its original certification proposal in June 2002. Members of this committee should probably include senior financial, legal and compliance officers.

[234] See Sarbanes-Oxley Section 404; Rule 13a-15(a) under the 1934 Act.

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control structure and procedures for financial reporting and (ii) an independent auditor's attestation and report. The SEC adopted rules implementing Sarbanes-Oxley Section 404 with regard to management's obligations to report on internal control structure and procedures on June 5, 2003.[235] Issues with the implementation of these rules led to significant amendments in 2007.[236] The independent auditor's attestation and report are not required for EGCs or issuers that are neither large accelerated filers nor accelerated filers.[237]

The SEC has issued interpretive guidance that sets forth an approach by which management can conduct a top-down, risk-based evaluation of internal control over financial reporting under Section 404. This guidance is broadly based on two principles: (i) management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner; and (ii) management's evaluation of evidence about the operation of its controls should be based on its assessment of risk to reliable financial reporting. The guidance itself, however, is not mandated and only represents one way to satisfy the annual evaluation requirement.[238] The independent auditors are required to render an opinion on the effectiveness of the issuer's internal control over financial reporting.[239]

Section 404 management assessment and auditor attestations of internal control and procedures are compulsory for large accelerated issuers and accelerated issuers. First-time registrants are exempt from these rules until their second annual report filed with the SEC; however, new registrants must comply with the auditor's report requirement at the time it furnishes its first management report on internal control over financial reporting.[240]

As discussed under the heading "Relationship Between "S" Forms and 1934 Act Filings" in Chapter 4 (*Disclosure Requirements*), an issuer's management must also include in a report on Form 10-K or 10-Q, any material changes to its internal control over financial reporting for the period covered by the report.[241] Internal control over financial reporting is defined as a process designed to "provide reasonable assurance regarding the reliability of

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[235] See SEC Release No. 33-8238 (June 5, 2003) (http://www.sec.gov/rules/final/33-8238.htm).

[236] See SEC Release No. 33-8809 (June 20, 2007) (http://www.sec.gov/rules/final/2007/33-8809.pdf).

[237] In 2010, the Dodd-Frank Act exempted smaller issuers (those that are not "large accelerated filers" or "accelerated filers") from the requirements of Section 404(b) of Sarbanes-Oxley (which contains the requirement for the independent auditor's attestation and report). (See Dodd-Frank Act Section 989G.) In 2012, the JOBS Act exempted EGCs from the requirements of Sarbanes-Oxley Section 404(b). (See JOBS Act Section 103.)

[238] See SEC Release No. 33-8810 (June 27, 2007) (http://www.sec.gov/rules/interp/2007/33-8810.pdf).

[239] See PCAOB Auditing Standard No. 5 (PCAOB Auditing Standard No. 5).

[240] See SEC Release No. 33-8760 (Dec. 15, 2006) (http://www.sec.gov/rules/final/2006/33-8760.pdf). As noted above, however, the independent auditor's report is not required for EGCs or issuers that are neither large accelerated filers nor accelerated filers.

[241] See Rules 13a-15(d) and 15d-15(d) under the 1934 Act.

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financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

(1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(2) provide reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in accordance with generally accepted accounting principles and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

(3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements."[242]

The internal control over financial reporting must be designed by the principal executive and financial officers (or under their direction) and effected by the board of directors, management and other personnel. The report must include an assessment of any material weaknesses in internal control that could adversely affect an issuer's ability to record, process, summarize and report financial data consistent with the statements of management in the issuer's financial statements. As defined in Rule 12b-2 under the 1934 Act, a "material weakness" is a deficiency, or a combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis.

Disclosure of Financial Experts on the Audit Committee[243]

A U.S. issuer must disclose in its annual report on Form 10-K whether at least one audit committee[244] member is an "audit committee financial expert" and, if not, why not and, if so, the name of the expert or experts.

An audit committee financial expert is defined as someone who:

- understands applicable generally accepted accounting principles and financial statements;

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[242] See Rules 13a-15(f) and 15d-15(f) under the 1934 Act.

[243] See Sarbanes-Oxley Section 407; Regulation S-K Item 407(d)(5); Form 10-K Item 10.

[244] Issuers that have securities listed on a registered U.S. securities exchange under the 1934 Act must have an audit committee. See Section 10A(m) of the 1934 Act and Rule 10A-3(a)(1) thereunder and Chapter 6 (*Listing on U.S. Securities Exchanges*).

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- can assess estimates, accruals and reserves under applicable general accepted accounting principles;
- has experience preparing, auditing, analyzing or evaluating financial statements comparable to those of the issuer, or experience actively supervising those who do so;
- understands internal controls over financial reporting; and
- understands audit committee functions.[245]

Under SEC rules, the expert may acquire the attributes through any one or more of the following:

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
- experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- other relevant experience.[246]

If a person qualifies as an expert by virtue of possessing "other relevant experience," the issuer's disclosure must briefly describe that experience.[247]

An audit committee financial expert is not deemed to be an expert for purposes of Section 11 of the 1933 Act or any other purpose. Further, pursuant to Item 407(d)(5)(iv) of Regulation S-K, a designation or identification as an audit committee financial expert will not impose on such person any duties, obligations or liabilities that are greater than the duties, obligations and liabilities imposed on any other member of the audit committee and board of directors in the absence of such designation or identification. Also, such designation or identification of an audit committee financial expert does not affect the duties, obligations or liabilities of any other member of the audit committee or board of directors.

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[245] See SEC Release No. 33-8177 (http://www.sec.gov/rules/final/33-8177.htm).

[246] See *supra* note 243.

[247] *Id.*

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An issuer that has listed securities on a U.S. securities exchange must disclose whether its audit committee financial expert is independent, as that term is defined by the applicable listing standards. An issuer with no listed securities must select one of the definitions of audit committee member independence used by a major U.S. securities exchange and disclose whether its audit committee financial expert is independent under that definition.[248] If an issuer does not have an "audit committee" (and if it is not listed in the U.S. it is not required to), its full board of directors will be deemed to be its audit committee and the issuer is required to provide disclosure as to whether there is an audit committee financial expert on its board of directors.[249]

Disclosure of Executive Officer Code of Ethics[250]

An issuer must disclose in its annual report on Form 10-K whether it has adopted a code of ethics for the issuer's principal executive officer, principal financial officer, principal accounting officer or controller, and persons performing similar functions or, if not, why not. Issuers are required to promptly disclose any changes or waivers to this code.

The term "code of ethics" is defined broadly to include standards promoting honest and ethical conduct, governing full, fair, accurate, timely and understandable disclosure in reports and documents the issuer files with or submits to the SEC, and compliance with applicable governmental laws and regulations. A copy of the code of ethics must be attached to the issuer's annual report, posted on the issuer's web site or provided free of charge on request.

Audit, Auditor and Audit Committee Requirements

Audit Committee Standards for Listed Issuers[251]

Sarbanes-Oxley Section 301 requires that the SEC mandate that all issuers with securities listed on a U.S. securities exchange have a fully independent audit committee of the board of directors. Pursuant to Sarbanes-Oxley Section 301, the SEC adopted Rule 10A-3 under the 1934 Act.[252] Rule 10A-3 implements the listing standard requirements

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248 See the discussion under the heading "Relationship Between "S" Forms and 1934-Act Filings 24. Directors and executive officers, compliance with Section 16(a) of the 1934 Act, code of ethics and corporate governance" in Chapter 4 (*Disclosure Requirements*). See also Form 10-K, Part III, Item 10. Directors, Executive Officers and Corporate Governance.

249 See Item 407(d)(5) of Regulation S-K.

250 See Sarbanes-Oxley Section 406; Item 406 of Regulation S-K; Form 10-K, Part III, Item 10. Directors, Executive Officers and Corporate Governance.

251 See Sarbanes-Oxley Section 301; Section 10A(m) of the 1934 Act; Rule 10A-3 under the 1934 Act.

252 SEC Release No. 33-8220 (Apr. 9, 2003) (http://www.sec.gov/rules/final/33-8220.htm).

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for audit committees required by Sarbanes-Oxley and requires certain additional disclosures. The audit committee standards require the following:

- *Independence*. Each member of an issuer's audit committee must be independent, *i.e.*, (A) no member or any specified relative may receive fees from the issuer other than as a director, although normal commercial transactions between the issuer and an entity with which the director has a relationship would be permitted, and (B) no member may be an affiliated person of the issuer or any subsidiary thereof.[253]

- *Authority to Engage Auditor*. The audit committee must have the authority to engage the issuer's auditor, including appointing, compensating, retaining and overseeing the work of the auditor and resolving disputes between management and the auditor.

- *Complaint Resolution Procedures*. The audit committee must establish procedures to receive, retain and resolve complaints regarding accounting, internal accounting controls and auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

- *Authority to Employ Advisors*. The audit committee must have the authority to engage independent counsel and other advisors necessary for the performance of its duties.

- *Appropriate Funding*. The audit committee must be appropriately funded.

If an issuer avails itself of any exemption under the rule, it must disclose, in its annual report on Form 10-K, that fact and any material impact on the independence of the audit committee and the other requirements of the rule.[254]

If an issuer does not have an audit committee, the rule requires disclosure that the issuer's board of directors is acting as the audit committee.

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[253] An "affiliate" or a person affiliated with a specified person means a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the specified person. For the purposes of the independence requirement, a person will not be deemed to control a specified person (such as an issuer or any subsidiary thereof) if that person (i) is not the beneficial owner, directly or indirectly, of more than 10% of any class of voting equity securities of the specified person and (ii) is not an executive officer of the specified person. See the immediately preceding footnote.

[254] Issuers that are subject to the proxy rules would have to similarly disclose reliance upon the exemption in proxy statements or information statements for shareholders' meetings at which elections for directors are held. See *supra* note 252.

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Audit Committee Pre-Approvals and Consultations[255]

An issuer's audit committee must pre-approve all audit services and permitted non-audit services provided by the issuer's auditors. An issuer's audit committee may delegate its pre-approval responsibilities if, pursuant to procedures detailed as to the particular service, the audit committee is informed of each non-audit service approved via delegation and the procedures do not delegate the audit committee's obligations to management.

Before the filing of an auditor's report with the SEC, the auditor must timely report to the issuer's audit committee:

- all critical accounting policies and practices to be used by the issuer;
- all alternative treatments of financial information within generally accepted accounting principles for policies and procedures related to material items discussed with management, and the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the auditors; and
- other material written communications provided by the auditor to management, such as any management letter or schedule of unadjusted differences.

Prohibition or Limitation of Specified Non-Audit Services[256]

An accounting firm may not provide specified non-audit services to an audit client, including:

- bookkeeping, financial information systems design and implementation, or appraisal or valuation services;
- fairness opinions or contribution-in-kind reports;
- actuarial services, internal audit outsourcing services, management functions or human resources;
- broker-dealer, investment advisor or investment banking services; or
- legal services or expert services unrelated to the audit.

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[255] See Sarbanes-Oxley Section 202; Section 10A(i) of the 1934 Act; Rule 2-01(c)(7) of Regulation S-X; Sarbanes-Oxley Section 204; Section 10A(k) of the 1934 Act; Rule 2-07(a) of Regulation S-X.

[256] See Sarbanes-Oxley Section 201 and Sections 10A(g) and (h) of the 1934 Act; Rule 2-01(c)(4) of Regulation S-X.

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An accounting firm may provide an issuer with tax services such as tax compliance, tax planning and tax advice but may not represent the issuer within a prohibited category before a court.

Rotation of Audit Partners[257]

Lead and concurring partners of an issuer's accountant must rotate every five years. A minimum five-year time-out period must apply before lead or concurring partners may rotate back to the issuer. Other partners who provide audit services to an issuer must rotate after seven years, with a minimum two-year time-out period between rotations.

Accounting Firms' Retention of Audit and Review Records[258]

The documents used by an accounting firm in conducting an audit or review of an issuer's financial statements completed on or after October 31, 2003, including workpapers, must be kept for seven years.[259] Certain documents, such as superseded drafts or other records such as e-mails, are not required to be kept unless they contain information relating to a significant matter that is inconsistent with the auditor's final conclusion on that matter, such as documentation of the consultation on or resolution of differences of professional judgment. In the event of a violation, criminal penalties may apply.

Limitation on Issuer's Employment of Former Member of Audit Engagement Team[260]

If an audit engagement team member of an accountant is employed by an issuer to serve in a "financial reporting oversight role" for the issuer and if that person performed audit-related work during the one-year period prior to that accounting firm's commencement of audit procedures for that issuer for a given year, the accounting firm is not independent with respect to that issuer.

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[257] See Sarbanes-Oxley Section 203 and Section 10A(j) of the 1934 Act; Rule 2-01(c)(6) of Regulation S-X.

[258] See Sarbanes-Oxley Section 802 and Rule 2-06 of Regulation S-X. See also SEC Release No. 33-8180 (Jan. 24, 2003) (http://www.sec.gov/rules/final/33-8180.htm).

[259] "Workpapers" are defined as the documentation of auditing or review procedures applied, evidence obtained, and conclusions reached by the accountant in the audit or review engagement, as required by the standards established or adopted by the SEC or the PCAOB. Rule 2-06(b) of Regulation S-X.

[260] See Sarbanes-Oxley Section 206 and Section 10A(l) of the 1934 Act; Rule 2-01(c)(2)(iii) of Regulation S-X. See also SEC Release No. 33-8183 (Jan. 28, 2003) (http://www.sec.gov/rules/final/33-8183.htm).

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Prohibition of Improper Influence on Conduct of Audits[261]

Under the SEC's rules, no officer or director of an issuer may make or cause to be made a materially false or misleading statement to an accountant, or omit to state, or cause another person to omit to state, any material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading, in connection with (i) any audit, review or examination of the financial statements of the issuer or (ii) the preparation or filing of any document or report required to be filed with the SEC.[262] Further, rules adopted by the SEC prohibit an issuer's directors and officers, and any other person acting under their direction, from taking action to coerce, manipulate, mislead or fraudulently influence any independent public or certified accountant engaged in the performance of an audit or review of financial statements that are required to be filed with the SEC, if that person knew or should have known that such actions, if successful, could render the financial statements materially misleading.[263]

Registration of Public Accounting Firms with the Public Company Accounting Oversight Board[264]

Rules adopted by the PCAOB pursuant to Sarbanes-Oxley Sections 102 and 106(a) require that any public accounting firm that "prepares or issues" or "plays a substantial role in the preparation or furnishing of" any audit report with respect to any "issuer," as that term is defined in Sarbanes-Oxley, and non-public broker-dealers register with the PCAOB.[265]

Requirements for Attorneys Representing Issuers[266]

SEC rules adopted pursuant to Sarbanes-Oxley Section 307 apply to attorneys who "appear and practice" before the SEC "in the representation of an issuer" that file periodic reports with the SEC. The rule requires in-house and outside attorneys appearing and practicing before the SEC in the representation of an issuer who become aware of "evidence of a material violation" of U.S. law that has occurred or is reasonably likely to occur, by the

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[261] See Sarbanes-Oxley Section 303; Rule 13b2-2 under the 1934 Act. See also SEC Release No. 34-47890 (May 20, 2003) (http://www.sec.gov/rules/final/34-47890.htm).

[262] See Rule 13b2-2(a) under the 1934 Act.

[263] See Rule 13b2-2(b) under the 1934 Act.

[264] See Sarbanes-Oxley Section 102; PCAOB Rule 2100.

[265] The phrase "plays a substantial role in the preparation or furnishing of an audit report" means (1) to perform material services that a public accounting firm uses or relies on in issuing all or part of its audit report with respect to any issuer or (2) to perform the majority of the audit procedures with respect to a subsidiary or component of any issuer the assets or revenues of which constitute 20% or more of the consolidated assets or revenues of such issuer necessary for the principal accountant to issue an audit report on the issuer. PCAOB Rule 1001(p)(ii).

[266] See Sarbanes-Oxley Section 307 and 17 CFR Part 205. See also SEC Release No. 33-8185 (Jan. 29, 2003) (http://www.sec.gov/rules/final/33-8185.htm).

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issuer or by an officer, director, employee or agent of the issuer, to report that violation internally to the issuer's chief legal officer (or equivalent) or to both the chief legal officer and the chief executive officer (reporting "up the ladder") forthwith and to determine whether an "appropriate response" has been made. In some cases, further reports to the board of directors or audit committee may be required or permitted. As an alternative to the above procedure, an attorney may notify the qualified legal compliance committee ("QLCC") of the issuer, if the issuer has previously formed such a committee. After reporting a material violation to the QLCC, the attorney has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence. A QLCC must:

- consist of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more independent members of the issuer's board of directors;

- be duly established and authorized by the issuer's board of directors; and

- have written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation.

"Appearing and practicing" is defined as:

(i) transacting business with the SEC, including communications in any form;

(ii) representing an issuer in an SEC administrative proceeding or an investigation, inquiry, information request or subpoena;

(iii) providing advice on U.S. securities laws or SEC rules or regulations regarding any document that the attorney has notice will be filed with, or submitted to, the SEC, including providing that advice in the context of preparing, or participating in the preparation of, such a document; or

(iv) advising an issuer whether information or a statement, opinion or other writing is required to be filed with, or submitted to, or incorporated into a document filed with, or submitted to, the SEC.

The phrase "in the representation of an issuer" applies to attorneys providing any legal services as an attorney for an issuer, regardless whether the attorney is employed or retained by the issuer.

"Evidence of a material violation" is defined as credible evidence, based upon which it would be unreasonable under the circumstances for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.

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A "material violation" is defined as a material violation of an applicable U.S. federal or state securities law, a material breach of fiduciary duty arising under U.S. federal or state law, or a similar material violation of any U.S. federal or state law.

An attorney supervising or directing another attorney who is appearing and practicing before the SEC in the representation of an issuer is a "supervisory attorney." An attorney who appears and practices before the SEC in the representation of an issuer under the supervision or direction of another attorney (other than the issuer's chief legal officer) is a "subordinate attorney." A supervisory attorney must make reasonable efforts to ensure that his or her subordinate attorney complies with the rule's reporting requirements. The supervisory attorney is responsible for complying with the reporting requirements when a subordinate attorney has reported evidence of a material violation to the supervisory attorney. The subordinate attorney must comply with the reporting requirements notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person. A subordinate attorney has complied with the reporting requirement once he or she has reported evidence of a material violation to the supervisory attorney.

A subordinate attorney that has reported evidence of a material violation to a supervisory attorney, but who believes that the supervisory attorney has failed to comply with the reporting requirements, would be permitted—but not required—to report the evidence "up the ladder" within the issuer or to the QLCC.

Authority for enforcement of requirements regarding attorneys representing issuers lies solely with the SEC, and the rules state that a private cause of action has not been created against attorneys. Violations could be grounds for SEC action against an attorney under Rule 102(e) of the SEC's Rules of Practice, which could result in the attorney being barred from practicing before the SEC.

Miscellaneous Requirements

Prohibition of Issuer Loans to Directors and Executive Officers[267]

Except as discussed below, it is unlawful for any issuer, directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit in the form of a personal loan to or for any of its directors or executive officers. Any extension of credit maintained by an issuer on July 30, 2002 is not subject to the prohibition, so long as there is no subsequent material modification to any term of the credit or renewal of the credit. Sarbanes-Oxley provides no guidance on whether a binding credit commitment that was unfunded on July 30, 2002 would represent an extension of credit that was maintained at that date, or whether a funded line of credit could be paid down and re-drawn after July 30, 2002.

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[267] See Sarbanes-Oxley Section 402 and Section 13(k) of the 1934 Act.

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Affected Executive Officers

The affected executive officers under Sarbanes-Oxley should be the same group identified as executive officers in the issuer's annual report. Although there are circumstances where an officer of a subsidiary can be an executive officer of the parent, loans to directors and officers of subsidiaries who are not directors or executive officers of the parent are not affected.

Permitted Loans

Travel advances, cash advances and issuer-sponsored credit cards should be permitted, provided they are used only in the ordinary course of business and, in the case of issuer-sponsored credit cards, the terms are not more favorable than the terms the issuer offers to the public.

Any loan made by an "insured depository institution," as defined in the Federal Deposit Insurance Act, is exempt from the prohibition if the loan is subject to the insider lending restrictions of the Federal Reserve Act.[268] Rule 13k-1 under the 1934 Act exempts from the insider lending prohibition those non-U.S. banks that meet specified criteria similar to those that qualify insured depository institutions for the exemption.

Additionally, an exemption applies to any registered broker-dealer extending credit to an employee of the broker-dealer for the buying, trading or carrying securities (other than credit extended for the purchase of the stock of that issuer) that (i) occurs in the ordinary course of the consumer credit business of such issuer, (ii) is of the type ordinarily made available by such issuer to the public and (iii) is made on market terms or terms no more favorable than those offered to the general public.

Chief Executive Officer and Chief Financial Officer Forfeiture of Bonus Following a Restatement[269]

If an issuer is required to restate its financial statements due to material non-compliance of the issuer, as a result of misconduct, with any financial reporting requirements under U.S. securities laws, the chief executive officer and chief financial officer are required to reimburse the issuer for any bonus, incentive compensation or equity-based compensation they received, during the twelve-month period following the first public issuance or filing with the SEC (whichever first occurs) of the financial document that required restatement. In addition, the chief executive officer and chief financial officer must reimburse the issuer for any profits they realized from the sale of the issuer's securities during that twelve-month period.

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[268] Section 13(k)(3) of the 1934 Act.

[269] See Sarbanes-Oxley Section 304.

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Whistleblower Protections[270]

Issuers that file periodic reports with the SEC (and their agents and certain other persons) may not retaliate against an "employee" because of the employee's alleged "whistle blower" activities. An employee protected by the prohibition has a private right of action against the employer.[271] The prohibition may also apply to employees of U.S. subsidiaries of a reporting company, whether the retaliation is alleged to have been originated with the parent company or with the U.S. subsidiary.

Criminal protections for employees against retaliation have been broadened and carry a penalty of imprisonment for up to ten years.[272]

An audit committee (or the full board if no audit committee exists) of a listed company is required to establish a procedure for employees to anonymously submit concerns regarding questionable accounting or auditing matters.[273]

Insider Trading Prohibited during Pension Blackout Periods[274]

The SEC has adopted rules (Regulation BTR) relating to insider trading during blackout periods under sponsored individual account plans. Under the rules, directors and executive officers of an issuer of any equity security may not, directly or indirectly, purchase or sell or otherwise acquire or transfer any equity security of the issuer (other than exempted securities) during any "blackout period" with respect to such equity security if the director or

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[270] See Sarbanes-Oxley Sections 301, 806 and 1107; Section 10A(m) of the 1934 Act. The American Recovery and Reinvestment Act of 2009 (the "ARRA") includes additional whistleblower provisions with respect to "covered funds." The ARRA defines "covered funds" as any contract, grant, or other payment received by any non-Federal employer if (A) the Federal Government provides any portion of the money or property that is provided, requested, or demanded; and (B) at least some of the funds are appropriated or otherwise made available by this Act. ARRA Section 1553 protects employees from a reprisal for disclosing to certain persons, including a State or Federal regulatory or law enforcement agency, a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct), a court or grand jury, the head of a Federal agency or their representative, information that the employee reasonably believes is evidence of: (1) gross mismanagement of an agency contract or grant relating to covered funds; (2) a gross waste of covered funds; (3) a substantial and specific danger to public health or safety related to the implementation or use of covered funds; (4) an abuse of authority related to the implementation or use of covered funds; or (5) a violation of law, rule, or regulation related to an agency contract (including the competition for or negotiation of a contract) or grant, awarded or issued relating to covered funds.

[271] 18 U.S.C. § 1514A(b)(1)(B).

[272] See Sarbanes-Oxley Section 1107; 18 U.S.C. § 1513(B).

[273] See Sarbanes-Oxley Section 301 and Rule 10A-3 under the 1934 Act.

[274] See Sarbanes-Oxley Section 306 and Regulation BTR.

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officer acquires the equity security in connection with his or her service or employment with the issuer.[275]

"Blackout period" means a period of more than three consecutive business days during which the ability of not less than 50% of the participants or beneficiaries who are located in the United States and participate in any individual account plan maintained by the issuer or any member of the issuer's group to purchase, sell or otherwise acquire or transfer an interest in an equity security of the issuer is temporarily suspended.[276]

BENEFICIAL OWNERSHIP REPORTING UNDER SECTION 13

The Williams Act imposes certain disclosure obligations on persons owning beneficially more than 5% of a voting class of equity securities registered under Section 12 of the 1934 Act. All such shareholders are required to file initial reports on Schedule 13D within ten days of the acquisition[277] or, where permissible, on the shorter form and more flexible timeframe[278] of Schedule 13G. Certain institutional investors specified in Rule 13d-1(b)(1)(ii) under the 1934 Act holding securities in the ordinary course of business and not with a control purpose are eligible to file a Schedule 13G rather than Schedule 13D.[279] All investors directly or indirectly beneficially owning less than 20% of the outstanding class that are not reporting as qualified institutional investors and that have not acquired and do not hold the securities for the purpose of changing or influencing the control of the issuer of the securities may also file a Schedule 13G.[280] Those persons already beneficially owning more than 5% of a voting class of an equity security at the time such equity security is registered pursuant to Section 12 must file a Schedule 13G within forty-five days of the end of the first calendar year during which they become subject to this requirement (*e.g.*, following an initial public offering of equity securities in the U.S. capital markets).[281]

Amendments to Schedule 13D are required to be filed promptly if any material changes in their holdings occur. Any acquisition or disposition of 1% or more of the same class of securities is deemed material. Any smaller change may be material depending on the

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[275] See Sarbanes-Oxley Section 306(a)(1); Rule 101(a) under Regulation BTR.

[276] See Sarbanes-Oxley Section 306(a)(4); Rule 100(b) under Regulation BTR.

[277] Rule 13d-1(a) under the 1934 Act.

[278] Filing required by February 14 of following year. Rule 13d-1(b) under the 1934 Act.

[279] In addition, non-U.S. institutional investors filing Schedule 13G would (1) certify that they are subject to a non-U.S. regulatory regime substantially comparable to their U.S. counterparts and (2) be required to furnish, upon SEC request, information otherwise provided in Schedule 13D. Rule 13d-1(b)(1)(i) under the 1934 Act and (ii); SEC Release No. 33-8957 (Sept. 19, 2008) (http://www.sec.gov/rules/final/2008/33-8957.pdf).

[280] Rule 13d-1(c) under the 1934 Act; Rule 3d-1(f) under the 1934 Act.

[281] Rule 13d-1(d) under the 1934 Act.

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circumstances.[282] Once a Schedule 13G filing has been made, a follow-up filing is not required if a change in the percentage of shares owned by a reporting person is caused solely by a change in the number of outstanding shares.[283] Amendments to Schedule 13G are, however, required for other changes to the amount of shares beneficially owned. Moreover, persons filing on Schedule 13G as passive investors would be required to amend and commence filing on Schedule 13D at such time as their ownership percentage exceeds 20% or their investment purpose no longer satisfies the passive criteria.

INSIDER TRADING AND SHORT SWING PROFIT RULES

Persons beneficially owning, directly or indirectly, more than 10% of any class of any registered security, or officers or directors of the issuer of such security must disclose such holdings within ten days of becoming such beneficial owner, officer or director.[284] Additional disclosure is required upon a change in such ownership or upon the purchase or sale of a security-based swap agreement.[285] In an effort to prevent beneficial owners, directors or officers from inappropriately capitalizing on inside information in connection with the ownership of such securities (or security-based swap agreements), profits acquired within a six-month period from certain purchases and sales or sales and purchases, as applicable, may be recovered by the issuer. If such profits are not recovered by the issuer, a shareholder may seek disgorgement of those profits.[286] The issuer or shareholder must bring suit no later than two years after the date the profit was realized.

PROXY RULES

As discussed under the heading "Disclosure Requirements of Proxy Statements" in Chapter 4 (*Disclosure Requirements*), with respect to securities registered under the 1934 Act, companies are subject to proxy disclosure requirements designed to enhance the information provided to shareholders and create transparency enabling shareholders to make more informed decisions.[287] The disclosure requirements broadly affect three categories, (i) risk, and specifically the board's role in risk oversight and, to the extent applicable, how an issuer's compensation policies could materially adversely affect the issuer, (ii) governance and director qualification, and specifically increasing the detail provided regarding the corporate structure and accelerating the time of such disclosure and (iii) compensation,

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[282] Rule 13d-2(a) under the 1934 Act.

[283] Rule 13d-2(b) under the 1934 Act.

[284] Section 16(a) of the 1934 Act. Form 3 is an initial statement of beneficial ownership. Form 4 is a statement of changes of beneficial ownership. Form 5 is an annual statement of beneficial ownership.

[285] Section 16(a)(2)(C) of the 1934 Act. "Security-based swap agreement" means a swap agreement as defined in Section 206A of the Gramm-Leach-Bliley Act.

[286] Section 16(b) of the 1934 Act. See also, "Selected Related Matters—Section 16" in Chapter 18 (*Acquisitions of U.S. Entities*).

[287] See SEC Release 33-9089 (Dec. 16, 2009) (http://www.sec.gov/rules/final/2009/33-9089.pdf).

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including disclosure of the fair value of any stock and option awards (at the time such awards were granted). In respect of any shareholder meeting, voting results must be disclosed in a Form 8-K; preliminary voting results must be disclosed within four business days of the relevant meeting and final voting results must be disclosed four business days after the final voting results are known.[288]

COMMUNICATIONS WITH INVESTORS AND THE PUBLIC

In addition to the specific filing and reporting requirements described above and Chapter 3 (*The Securities Registration and Reporting Process*) and Chapter 4 (*Disclosure Requirements*), the anti-fraud provisions of the U.S. federal securities laws and reporting requirements of the relevant U.S. securities exchanges give rise to a general obligation to report material events promptly to investors.[289]

Press Releases

Typically, the obligation to report material events to shareholders is satisfied through a press release. In most cases, press releases are distributed to the wire services and other financial information channels. Certain developments are appropriate for public disclosure, but may not be so critical as to require an immediate press release. Such developments may be communicated in the issuer's interim reports.

Press releases must avoid material misstatements or omissions. A high degree of accuracy, completeness and balance between positive and negative factors is required. There is no room for the degree of "puffery" in financial disclosures that might be acceptable in general commercial advertising or other areas of commercial communication.

Communications with Analysts

An issuer may have individual discussions with an analyst covering general or background information. It is important, however, not to release "material" non-public information to a person who may purchase or sell securities based on that information without simultaneously releasing it to the general financial community. Disclosing material non-public information selectively to analysts that regularly follow the issuer's stock or selectively to large shareholders raises questions of improper motive and risks charges of "insider trading."[290] For example, if an issuer has a specific material internal projection of

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[288] See SEC Release 33-9089 regarding the enhanced proxy disclosure rules. See also Rule 14a-21 of the Proxy Rules. (Voting results no longer must be disclosed on Forms 10-K or 10-Q.)

[289] U.S. courts, however, have recognized that a variety of proper business purposes will justify a delay in disclosure. See the discussion in this chapter below under the heading "Communications with Investors and the Public—Duty to Disclose."

[290] See the discussion under the heading "1934 Act—Insider Trading" in Chapter 16 (*Liabilities Under U.S. Securities Laws*).

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earnings which is disclosed to one analyst (whether intentionally or inadvertently), it may become necessary to disclose the information to the public at large.[291]

Materiality Standards

While there is no standard that can be applied with mechanical certainty, a fact will be considered "material" if there is a substantial likelihood that reasonable investors would consider it important, as part of the total mix of available information, in reaching their investment decisions (that is, if the investors would attach actual significance to the information in their deliberations). It is impossible to make a complete catalog of all material information, but typical examples include significant mergers or acquisitions, stock splits, adoption of a dividend policy or changes in dividends, major increases or decreases in revenues or profits, important new contracts or projects, and changes in senior corporate management or basic corporate business policies.

In this regard, courts have treated the confirmation of a general market expectation as being material information in some circumstances. For example, if an issuer confirms to one analyst the accuracy of its projection that it will achieve a specific level of earnings, this confirmation may give the analyst "material information," and may trigger the obligation to make a general public announcement, even if outside analysts are also arriving at the same projection based on their own analyses of published data.

Duty to Disclose

It is generally recognized that good corporate practice requires prompt public disclosure of material events. There has been some discussion among legal practitioners, however, concerning the extent to which the law requires such disclosure.

Under the 1934 Act, an issuer must file a Form 8-K that reports specified events generally within four business days of the event.[292] The anti-fraud rules, such as Rule 10b-5 under the 1934 Act, prohibit material misstatements and the omission of material information necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. They do not, however, deal directly with total silence.

An issuer with securities listed on a U.S. securities exchange is subject to additional affirmative obligations, imposed by the specific exchange, to make timely public disclosure of material information. For example, Section 202.05 of the NYSE Listed Company Manual states: "A listed company is expected to release quickly to the public any news or

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[291] See discussion of Regulation FD in this chapter below under the heading "Communications with Investors and the Public—Regulation FD."

[292] See "Current Reports: Disclosure and Signing Requirements of Form 8-K" in Chapter 4 (*Disclosure Requirements*).

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information which might reasonably be expected to materially affect the market for its securities. This is one of the most important and fundamental purposes of the listing agreement which the company enters into with the Exchange." Similarly, Nasdaq Rule 5250(b)(1) provides: "Except in unusual circumstances, a Nasdaq-listed company shall make prompt disclosure to the public through any Regulation FD compliant method (or combination of methods) of disclosure of any material information that would reasonably be expected to affect the value of its securities or influence investors' decisions." However, U.S. courts have held that there is not a private right of action for a violation of rules of a securities exchange.

Arguably, an issuer does not violate any legal requirements if, for good business reasons, it delays an announcement of important developments, absent special circumstances creating an affirmative duty to disclose. There may be an affirmative duty to disclose when there has been a news leak or selective disclosure by the issuer or one of its officers, when insider trading has occurred, when the issuer is acquiring its own equity securities or when there is a rumor or a market report circulating for which the issuer has some responsibility.

Notwithstanding the foregoing, the SEC's enforcement policies, as well as the trend of the law as interpreted by the courts, favor full and fair disclosure. Accordingly, withholding material information is not recommended unless there is a countervailing, *bona fide* and important business reason for doing so. In general, issuers subject to the U.S. federal securities laws should adopt a policy of disclosing material events on a timely basis.

Regulation FD

Regulation FD (Fair Disclosure) applies to all U.S. public companies reporting under the 1934 Act, including closed-end investment companies, but not including other investment companies. Regulation FD is designed to restrict "selective disclosure," which the SEC considers as the disclosure of material non-public information on a limited, rather than widespread, basis. The SEC believes that this practice provides the privileged parties that receive such information with an unfair advantage over the investing public-at-large.

In general, issuers subject to the regulation must ensure that any material non-public information intentionally disclosed to certain specified persons outside the issuer is simultaneously disclosed to the public-at-large (in the case of a "non-intentional" disclosure, public disclosure must be made "promptly"[293]). To some extent, Regulation FD is simply a codification of the SEC's previous position on permissive and non-permissive selective

[293] "Promptly" means "as soon as reasonably practicable (but in no event after the later of twenty-four hours or the commencement of the next day's trading on the New York Stock Exchange)" after a senior official of the issuer (or, in the case of a closed-end investment company, a senior official of the issuer's investment adviser) learns of the non-intentional disclosure by the issuer or person acting on behalf of the issuer and the senior official knows (or is reckless in not knowing) that the relevant information is both material and non-public. Rule 101(d) under Regulation FD.

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disclosure by registered public companies under the SEC's anti-fraud rules under the 1934 Act (including Rule 10b-5[294]).

In addition to the SEC's adoption of Regulation FD, many foreign regulators impose analogous requirements relating to the disclosure of material, non-public information including, for example, pursuant to the European Union's Market Abuse Directive as implemented in the various member states of the European Economic Area.

Operation of Regulation FD

Regulation FD addresses the problem of selective disclosure by providing that whenever a U.S. public company (or any of its directors, executive officers, investor relations or public relations officers or any other officer, employee or agent who regularly communicates with securities industry professionals or holders of the issuer's securities) discloses material non-public information regarding the issuer or its securities to a securities industry professional (such as a broker, dealer or investment adviser) or a holder of the issuer's securities, then the issuer is required to make public disclosure of that information. In the case of an intentional disclosure, public disclosure must be made simultaneously. Regulation FD is technically a reporting rule, not an anti-fraud measure, although the regulatory concerns leading to the adoption of Regulation FD are very similar to those policed by the anti-fraud rules (including Rule 10b-5).

Regulation FD generally does not apply to disclosures by an issuer made (i) to a person owing a duty of trust or confidence to the issuer (such as an attorney, investment banker or accountant), (ii) to a person who expressly agrees to maintain the information in confidence (and not use it for trading) and (iii) in certain registered public offerings of securities.

Discussions with Analysts and Disclosures to the Financial Community

Discussions with securities analysts have historically presented difficult questions for financial officers of public companies. The SEC has recognized the benefit that informed analysts provide to the market and has indicated on several occasions that issuers should not be discouraged from disseminating information to analysts. Nevertheless, if an analyst is

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[294] Section 10(b) of the 1934 Act and Rule 10b-5 thereunder impose liability for fraud committed in connection with the purchase or sale of any security. Rule 10b-5 provides that it is unlawful in connection with the purchase or sale of any security for any person to (1) employ any device, scheme, or artifice to defraud, (2) make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. Rule 10b-5 has been construed to prohibit insiders from engaging in a purchase or sale while in possession of inside information. See the discussion under the heading "1934 Act – Insider Trading" in Chapter 16 (*Liabilities Under U.S. Securities Laws*) for further analysis of the anti-fraud rules.

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provided with material information that has not been made available to the public, severe consequences can befall the issuer.

An example of the potential problems is presented by the pre-Regulation FD case of SEC v. Bausch & Lomb,[295] in which the SEC brought an enforcement proceeding against the chairman of Bausch & Lomb on the basis of various statements that he made to securities analysts regarding the issuer's business and prospects. The issuer's chairman had held a series of private meetings with analysts over several days. After the last meeting, in reaction to a rumor that the chairman had leaked a quarterly earnings estimate to one of the analysts, the chairman called an analyst and in this call released a specific corrected earning estimate that had not yet been publicly disseminated. Although the SEC did not prevail in the Bausch & Lomb case, it presents an instructive case study of the dangers presented when communicating with analysts.

The general rule when dealing with analysts is: Do not provide analysts with material information that is not public. If a spokesperson of the issuer has done so, a press release should be issued immediately in order to make the information available to the entire investing public. It is also advisable to limit the group of individuals authorized to speak with analysts or the press to one or two senior officers.

Information is generally considered "material" if there is a substantial likelihood that a reasonable investor would consider it important in reaching his or her investment decision. As can be seen from Bausch & Lomb and the SEC Regulation FD actions discussed below, earnings forecasts are likely to be found material.

SEC Regulation FD Actions

The following actions by the SEC illustrate its commitment to zealously enforce Regulation FD and its willingness to seek large penalties from issuers, as well as from individual executives, who violate the Regulation's disclosure requirements. The actions are briefly summarized below.

In Secure Computing Corporation and John McNulty,[296] Secure Computing, the issuer, had entered into an agreement with one of the nation's largest computer networking companies to bundle one of its products with the buyer's network systems. Mr. McNulty, Secure Computing's CEO, disclosed material non-public information about the contract on March 6 and 7, 2002. The initial March 6 disclosures were apparently unintentional since Mr. McNulty had mistakenly believed that existence of the contract was already publicly disclosed. Thus, Secure needed to make prompt public disclosure of the information concerning the contract. However, prior to such public disclosure and after being informed of the non-public nature of the information, Mr. McNulty again selectively disclosed the

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[295] *SEC v. Bausch & Lomb*, 420 F.Supp. 1226 (S.D.N.Y. 1976), aff'd, 565 F.2d 8 (2d Cir. 1977).

[296] SEC Release No. 34-46895 (Nov. 25, 2002) (http://www.sec.gov/litigation/admin/34-46895.htm).

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information. Secure Computing made public disclosure in a press release describing the contract three hours after Mr. McNulty had disclosed information to a portfolio manager on March 7. The press release did not afford a valid defense to a violation of Regulation FD because the regulation requires simultaneous public disclosure, except in unintentional cases, where "prompt" public disclosure must be made.

In Siebel Systems, Inc. ("Siebel I"),[297] Siebel's CEO made positive comments about the issuer's business that were based on what the issuer was observing in its sales pipeline at an invitation-only technology conference sponsored by an investment bank. This was in direct contradiction to negative statements the CEO had made three weeks earlier, in which he predicted a bleak business environment for the information technology market and said Siebel's weak performance would continue for the rest of the year. Siebel failed to make simultaneous disclosure of the CEO's optimistic statements to the public and therefore was found to have violated Regulation FD.

In Raytheon Company and Franklyn A. Caine,[298] Raytheon's chief financial officer held one-on-one telephone calls with sell-side analysts whose earnings per share estimates were included in Thomson Reuter's First Call Service. Realizing that the analysts' projections were less seasonal than Raytheon's internal forecasts, the CFO held "one-on-one conversations" with most of the sell-side analysts who covered Raytheon, in which he disclosed that in 2001, Raytheon's earnings would have the same seasonal distribution as in 2000, and more specifically, that Raytheon would generate one-third of their earnings per share in the first half of the year and the remaining two-thirds in the second half of the year. Raytheon did not provide any comparable quarterly earnings guidance in its public investor conference calls. Its disclosures during the phone calls with analysts were therefore found to be violations of Regulation FD.

In its Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Motorola, Inc.,[299] the SEC found that Motorola's Director of Investor Relations, in private telephone conversations with analysts, elaborated on the meaning of "significant weakness" in sales, as the phrase had been described in Motorola's earlier press release and public conference calls. In the private discussions, he mentioned that a "significant" drop meant a 25% or more decline and suggested that this should be reflected in the analysts' research notes. The SEC noted that Motorola should have issued a new press release or made another timely public disclosure of this additional information instead of disclosing the corrected message in private communications with industry professionals. However, the SEC did not issue a cease-and-desist order because the director had acted in good faith based on legal advice of Motorola's in-house counsel.

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[297] SEC Release No. 34-46896 (Nov. 25, 2002) (http://www.sec.gov/litigation/admin/34-46896.htm).

[298] SEC Release No. 34-46897 (Nov. 25, 2002) (http://www.sec.gov/litigation/admin/34-46897.htm).

[299] SEC Release No. 34-46898 (Nov. 25, 2002) (http://www.sec.gov/litigation/investreport/34-46898.htm).

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In Schering-Plough Corporation and Richard J. Kogan,[300] Kogan, Schering-Plough's CEO, held private meetings with analysts and portfolio managers. The SEC determined that Schering violated Regulation FD and that the CEO caused such violations by providing guidance that included material non-public information about the issuer's earnings prospects during the private meetings, and by failing to make public disclosure of the information as required by Regulation FD. The SEC noted that the CEO's "statements, demeanor and general expressions of concern for Schering's prospects" amounted to prohibited selective disclosure.

In Senetek PLC,[301] the issuer's CFO and CEO provided material non-public information about Senetek's projected earnings to two analysts covering the issuer. The SEC determined that Senetek violated Regulation FD by disclosing this information on both occasions without simultaneously disclosing such information publicly.

In Flowserve Corporation[302] the issuer's CEO reaffirmed publicly-released earnings guidance and provided additional material non-public information at a private analyst event in violation of Regulation FD.

In the second enforcement action against Siebel Systems, Inc. under Regulation FD ("Siebel II"), the SEC filed a civil action against Siebel charging the issuer, its CFO and its former investor relations ("IR") director with a violation of Regulation FD and of a prior cease-and-desist order, made in Siebel I, barring it from future violations of Regulation FD.[303] In its complaint, the SEC alleged that Siebel's CFO released material non-public information by making optimistic comments (stating that its sales pipeline was "growing" or "building") in private meetings with institutional investors that contrasted with allegedly less optimistic public statements made in the three weeks prior (qualifying that the issuer's performance would depend upon the overall performance of the economy). The U.S. District Court for the Southern District of New York dismissed all claims against Siebel, its CFO and the former IR director, finding that the private statements made by Siebel's officers did not constitute material non-public information.[304] Taking the private statements in context, the Court found that they did not add to, contradict or significantly alter the material information that was publicly available. The Court criticized the SEC for overzealous enforcement efforts, stating that the SEC was placing "an unreasonable burden on an issuer's management and spokespersons to become linguistic experts, or otherwise live in fear of violating

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[300] SEC Release No. 34-48461 (Sept. 9, 2003) (http://www.sec.gov/litigation/admin/34-48461.htm).

[301] SEC Release No. 34-50400 (Sept. 16, 2004) (http://www.sec.gov/litigation/admin/34-50400.htm).

[302] SEC Release No. 34-51427 (Mar. 24, 2005) (www.sec.gov/litigation/admin/34-51427.pdf).

[303] SEC Litigation Release No. 18766 (June 29, 2004) (http://www.sec.gov/litigation/litreleases/lr18766.htm).

[304] *SEC v. Siebel Systems, Inc.*, 2005 WL 2100269 (S.D.N.Y. Sept. 1, 2005).

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Regulation FD should the words they use later be interpreted by the SEC as connoting even the slightest variance from the issuer's public statements."[305]

In Electronic Data Systems Corporation,[306] the issuer selectively disclosed the amount that it would be required to pay under certain derivative contracts to securities professionals at three broker-dealers on September 19 and 23, 2002. The issuer publicly announced that it had settled the contracts through issuance of other securities on September 24, 2002 but it was not until its 2002 third quarter Form 10-Q (filed more than fifty days later) that it publicly disclosed the $225 million cost of settlement and other material information. The SEC found this to be a violation of Regulation FD and Section 13(b) of the 1934 Act.

In Christopher A. Black,[307] Christopher A. Black, the CFO of American Commercial Lines, Inc. ("ACL"), sent an e-mail on a Saturday to eight sell-side analysts disclosing ACL's significantly revised guidance for that quarter along with his own analysis. The following Monday, ACL's stock price dropped 9.7% on unusually heavy volume. On Monday morning, ACL's CEO learned of Mr. Black's e-mail and ACL publicly disclosed the content of Mr. Black's e-mail by filing a Form 8-K at the end of the trading day. In the litigation release discussing the settlement the SEC cited several factors that were considered in the determination not to bring an enforcement action against ACL: (1) ACL cultivated an environment of compliance by providing training regarding the requirements of Regulation FD and by adopting policies that implemented controls to prevent violations; (2) Mr. Black alone was responsible for the violation and he acted outside the control systems established by ACL to prevent improper disclosures; (3) once the illegal disclosure was discovered by ACL, it promptly and publicly disclosed the information by filing a Form 8-K with the SEC the same day; (4) ACL self-reported the conduct to the staff the day after it was discovered and provided extraordinary cooperation with the SEC's investigation; and (5) ACL took remedial measures to address the improper conduct, including the adoption of additional controls to prevent such conduct in the future.[308]

In Presstek, Inc. and Edward J. Marino,[309] Edward J. Marino ("Marino"), the President and CEO of Presstek, breached an internal policy of "corporate silence" and informed a managing partner of an investment adviser, whom he knew to be an institutional investor holding shares of Presstek, that third quarter 2006 earnings would be materially worse than projected estimates. Based on this disclosure of material non-public information, the managing partner arranged to sell substantially all of the investor's holdings in Presstek by the end of that day. That day Presstek's stock fell by 19%. Neither Marino nor Presstek

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[305] *Id.*

[306] SEC Release No. 34-56519 (Sept. 25, 2007) (http://www.sec.gov/litigation/admin/2007/34-56519.pdf).

[307] SEC Release No. 34-60715 (Sept. 24, 2009) (http://www.sec.gov/litigation/admin/2009/34-60715.pdf).

[308] SEC Litigation Release No. 21222 (Sept. 24, 2009) (http://www.sec.gov/litigation/litreleases/2009/lr21222.htm).

[309] SEC Release No. 34-66990 (May 15, 2012) (http://www.sec.gov/litigation/admin/2012/34-66990.pdf).

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simultaneously disclosed the material information to the public and the press release issued the following day conveyed only that the company's financial performance was below its prior estimates.

In Office Depot, Inc.[310] Office Depot attempted to temper what it considered unsustainable earnings per share growth expectations by providing information to selective analysts. In February, April and May of 2007, the CEO and CFO publicly cautioned that the company anticipated slow growth and faced a softening of demand in major business segments. Despite such warnings, analysts' consensus remained high and in June 2007 the CEO and CFO initiated a plan to selectively call analysts and institutional investors reminding them of previously released cautionary statements and pointing out that Office Depot competitors had recently released lower than expected earnings. Many analysts lowered their expectations as a result of the calls. Six days after the calls began, Office Depot filed a Form 8-K announcing only that earnings would be negatively impacted by soft economic conditions. The SEC determined that Office Depot violated Section 13(a) of the 1934 Act and Regulation FD. This determination was based in large part on Regulation FD's restriction on communicating non-public information selectively to analysts concerning anticipated earnings whether expressly or through indirect guidance and Office Depot's failure to promptly notify the public after such disclosure was made.

In Fifth Third Bancorp,[311] Fifth Third provided the requisite thirty-day notification to the Depository Trust Company of its plan to redeem certain trust preferred securities, but failed to publicly disclose the redemption plan. After Fifth Third noticed unusually high trading volume in the securities following the selective disclosure, they filed a Form 8-K publicly disclosing the redemption. The SEC agreed to the imposition of a cease-and-desist order prohibiting Fifth Third from committing or causing any further violations of Section 13(a) of the 1934 Act, and Regulation FD; no civil penalty was imposed. Fifth Third's remedial acts, including compensating harmed investors, and their cooperation with the SEC's investigation were considerations in the SEC's decision.

In its Report of Investigation Pursuant to Section 21(a) of the Securities Act of 1934: Netflix, Inc., and Reed Hastings,[312] the SEC provided guidance on the use of social media channels to disclose material non-public company information. In July 2012, Netflix's CEO Reed Hastings used his personal Facebook page to announce Netflix had streamed 1 billion hours of content in the month of June. This information was not released through any other medium, including on the company website, company blogs, a press release or the filing of a Form 8-K. Further, prior to this posting, Hastings had never used his personal Facebook page to disseminate information regarding company metrics nor had Netflix previously made investors aware that company information would be disclosed in this manner. Though the

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[310] SEC Release No. 34-63152 (Oct. 21, 2010) (http://www.sec.gov/litigation/admin/2010/34-63152.pdf).

[311] SEC Release No. 34-65808 (Nov. 22, 2011) (http://www.sec.gov/litigation/admin/2011/34-65808.pdf).

[312] SEC Release No. 34-69279 (Apr. 2, 2013) (http://www.sec.gov/litigation/investreport/34-69279.pdf).

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SEC did not initiate enforcement action against Netflix or Hastings, in a report of investigation issued on April 2, 2013, it noted that with respect to using social media to disclose company information, the SEC's August 2008 Commission Guidance on the Use of Company Web Sites[313] (the "2008 Guidance") provided a relevant framework for applying Regulation FD. Further, the SEC reiterated that investors must be made aware of the channels through which a company will distribute material information and that in determining a "recognized channel of distribution" is dependent on the steps that a company has taken to alert investors to its disclosure practices. In response to the SEC's report, Netflix filed a Form 8-K expressly listing the social media sites on which the company would post information.

Lessons to be Learned from Regulation FD Enforcement Actions

First, senior officials of issuers should be extremely cautious in private conversations with analysts. As the SEC noted in Office Depot, citing the adopting release for Regulation FD, "[w]hen an issuer official engages in a private discussion with an analyst who is seeking guidance about earning estimates, he or she take on a high degree of risk under Regulation FD." As the actions indicate, private disclosure to analysts and other covered persons under Regulation FD concerning estimates and similar information relevant to corporate earnings will likely result in an allegation of a violation of Regulation FD. The SEC noted that a violation of Regulation FD will be more probable when officials of issuers deliberately call investment analysts (as was the case in Raytheon, Motorola and Office Depot) than in a situation where the topic comes up unexpectedly during discussions. Nevertheless, whenever possible, an official familiar with Regulation FD and determinations of materiality should accompany senior officers to meetings with analysts and investors to serve as a witness as to what is disclosed, to guard against inadvertent disclosures and to ensure that unintentional disclosures are promptly remedied.

Second, issuers should bear in mind that the SEC threshold for "material" information is apparently quite low. Regulation FD applies the definition of "materiality" established by

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[313] Commission Guidance on Use of Company Web Sites, Release No. 34-58288 (Aug. 7, 2008) (http://www.sec.gov/rules/interp/2008/34-58288.pdf). The 2008 Guidance considered, among other things, when information posted on corporate websites could be considered sufficiently "public" for purposes of Regulation FD. The 2008 Guidance stated that a company makes public disclosure for Regulation FD purposes when it distributes information through a "recognized channel of distribution." Whether a corporate website constitutes a "recognized channel of distribution" depends on, among other things, whether the company has made investors, the market and the media aware that the website will be used for the company's disclosures of material information. Proper advance notice to investors (such as on the company's website) of the specific social media sites a company will use to disseminate material non-public information typically is necessary to conclude that such disseminations are made through recognized channels of distribution. However, notice to investors alone is not sufficient to create a recognized channel of distribution for Regulation FD purposes. Companies will also have to consider other factors, most importantly, the extent to which information posted on a social media site is regularly picked up by the market and reported in the media. The volume and nature of the information disseminated on the social media site may also bear on the issue.

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existing case law. Information is material if there is a substantial likelihood that a reasonable investor would consider the information important or if the information would significantly alter the total mix of available information (the formulation used by the Supreme Court in Basic, Inc., v. Levinson[314]). The SEC, however, appears to treat any issuer guidance concerning its earnings as categorically material. Under this view, the earnings guidance in Raytheon was material simply by reason of the subject matter. Even simple clarification or quantitative definition of qualitative terms—clarifying information that "significant" decline in sales meant more than a 25% drop—is likewise material in the SEC's view (although the decision in Siebel II may provide issuers with some latitude in embellishing on prior guidance). The materiality element of a Regulation FD violation may be easier for the SEC to prove when the issuer's stock price fluctuates significantly immediately following the disclosure in question, as in the Secure Computing, Siebel I, Raytheon and Fifth Third cases above.

Third, when a selective disclosure is not intentional, an issuer should make prompt public disclosure of the information to avoid a Regulation FD violation. In Secure Computing, the CEO's first disclosure of material information to portfolio managers was unintentional, because of his erroneous belief that the information had already been published. Even after he learned that the information had not yet been publicly disclosed, he made a further disclosure of the information to another portfolio manager which itself was a violation of Regulation FD in as much as simultaneous public disclosure was not made. Furthermore, since the issuer's press release following the first disclosure was more than twenty-four hours after a senior officer had learned of the problem, the maximum allowed in unintentional cases, the press release was not the "prompt" public disclosure required after the first selective disclosure. In contrast, in Black, prompt public disclosure of the information and self reporting of the conduct were important factors in the SEC's decision not to pursue an enforcement action against ACL and in Fifth Third, the prompt public disclosure upon recognition of the redemption's materiality and the voluntary nature of the remedial actions taken were considerations in the SEC's decision not to pursue civil penalties.

Fourth, when an issuer makes public disclosure of material information but later learns that it did not fully communicate the intended message, it should make additional public disclosure. In Motorola, when the director of investor relations realized that the investment house analysts did not reflect Motorola's "significant" drop in sales in their research notes, he individually contacted selected analysts to quantify earnings information. The SEC indicated that Motorola should have made broad public disclosure of the additional information. Similarly, in Office Depot, when analysts' estimates remained high despite the company's cautioning that it anticipated slow growth, the CEO implemented a strategy of calling specific analysts in an attempt to convey information that would result in such analysts lowering their estimates and then specifically sought to convey the same information

[314] 485 U.S. 224 (1988).

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to a select group of institutional investors. The SEC indicated that Office Depot's failure to make a public disclosure violated Regulation FD.

Fifth, although the SEC only published an investigation report in Motorola, the report warns that the advice of counsel is not a reliable defense to liability. In Motorola, in-house counsel advised the director of investor relations that he could contact selected analysts to provide them quantitative definitions of qualitative terms, based on the good-faith belief — albeit mistaken in the SEC's view — that the quantification was not material. The SEC stated that it did not take enforcement action against Motorola because legal advice was sought and given in good faith. However, the SEC noted that consultation with counsel will not relieve the officer from responsibility and that the SEC is less likely to credit reliance on counsel's advice after Motorola.

Sixth, notwithstanding the Court's decision in Siebel II, issuers should not relax their Regulation FD compliance practices and procedures. In Siebel II, the Court determined that the particular private statements before it did not constitute disclosure of material non-public information. However, determinations as to what constitutes material non-public information are extremely difficult and are dependent upon an in-depth analysis of the facts and circumstances presented. Any determination that information is immaterial may be viewed skeptically by courts or the SEC with the benefit of hindsight.

Seventh, Black and Fifth Third demonstrates that an issuer's good compliance environment, cooperation with the SEC, and remedial actions also play an important role in the SEC's decision not to pursue an enforcement action and should always be cultivated.

Eighth, the NetFlix Report makes clear that any information released via social media is subject to Regulation FD. Although the SEC elected not to pursue an enforcement action due to the "market uncertainty about the application of Regulation FD to social media," the Report indicates the SEC's belief that Netflix and its CEO were not in compliance with the SEC's 2008 Guidance and thus violated Regulation FD. With the Report, companies have now been warned of the SEC's position and should ensure that any disclosure of material non-public information through the means of social media should be done in compliance with the 2008 Guidance.

Procedures to Guard Against Inadvertent Selective Disclosure

To effect a policy of timely disclosure, an issuer should, to the extent it has not done so already, adopt internal procedures regarding disclosures to the financial community.[315]

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[315] In addition to the internal procedures adopted with respect to disclosures to the financial community, as discussed above, Rules 13a-15 and 15d-15 under the 1934 Act require every company reporting under the 1934 Act to maintain "disclosure controls and procedures" that are designed to ensure that information required to be disclosed under the 1934 Act is recorded, processed, summarized and reported within the required time periods. See the discussion in this chapter above under the heading "Sarbanes-Oxley–
(continued)

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The issuer should be certain that material information is disclosed on a timely basis when appropriate, and that there are no leaks or inadvertent disclosures when the release of information is inappropriate. There should be clear lines of authority and responsibility within the issuer, and the number of persons authorized to deal with the financial community should be limited. All employees should be alerted to these basic principles, with particular emphasis on the obligations to maintain the confidentiality of undisclosed material information and to refrain from trading while privy to such information.

The person or persons authorized to deal with the financial community should be kept informed about material developments, or should be instructed not to make comments until the accuracy of information regarding such developments is verified by more senior officials.

As a corollary to the foregoing, it is essential that the confidentiality of material information be strictly maintained within the issuer by all persons who may have access to that information, regardless of title or position. An issuer normally has some degree of discretion in determining when an event is ripe for public disclosure, assuming that no leaks have occurred. A reasonable standard, consistently applied for affirmative as well as negative information, usually will avoid difficulties. There are certain circumstances, however, where an issuer may be required to disclose, in accordance with good practice. Examples would include a leak of information or where rumors are circulating in the financial community that can be attributed to the issuer. Care should be taken to prevent these circumstances.

FOREIGN CORRUPT PRACTICES ACT OF 1977 ("FCPA")

The FCPA entails two primary requirements for issuers that are subject to the FCPA: first, the anti-bribery provisions, codified in Section 30A of the 1934 Act, prohibit bribery of foreign officials, and second, the accounting provisions, codified in Section 13(b) of the 1934 Act, impose certain recordkeeping and internal controls requirements. The FCPA applies to issuers with securities, including ADRs, registered under the 1934 Act or that are required to file reports under Section 15(d) of the 1934 Act.[316]

FCPA Anti-Bribery Provisions. Section 30A of the 1934 Act contains the FCPA anti-bribery provision applicable to certain issuers. Section 30A prohibits subject issuers from offering, paying, promising to pay, or authorizing the payment of anything of value,

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Disclosure and Related Requirements–Disclosure Certification, Controls and Procedures" and Chapter 4 (*Disclosure Requirements*).

[316] The FCPA also includes parallel anti-bribery provisions (not covered here) that apply to (i) non-issuer "domestic concerns" (*i.e.*, companies organized in the United States or with their principal place of business in the United States) and (ii) any persons other than issuers or domestic concerns that take any act in furtherance of a bribe of a foreign official while in the territory of the United States.

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directly or indirectly, to any foreign official[317] in order to assist the issuer in obtaining or retaining business, directing business to any person or securing any improper advantage. Amendments to the FCPA have provided for nationality jurisdiction that extends to the conduct of U.S. issuers anywhere in the world. By contrast, foreign issuers are subject to FCPA jurisdiction only for those acts that affect United States interstate commerce. In recent enforcement actions, the SEC and the Department of Justice ("DOJ") have aggressively expanded their interpretation of the FCPA's jurisdictional reach, bringing cases against non-U.S. persons and entities based on telephone calls or emails inside the United States in furtherance of a scheme to bribe a foreign official, or based on the conduct of United States subsidiaries of foreign issuers.

The FCPA includes some affirmative defenses. The most important affirmative defense covers reasonable and bona fide expenditures on a foreign official that are directly related to the promotion, demonstration or explanation of the payor's products or services. The FCPA also includes an exception for facilitating or expediting payment made to a foreign official, political party or party official, the purpose of which is to expedite or to secure the performance of a routine governmental action by a foreign official, political party or party official. In practice, satisfying the requirements of the facilitating payments exception can be challenging.

FCPA Accounting Provisions. Issuers subject to the FCPA must maintain books, records and accounts which, in reasonable detail, accurately and fairly reflect the issuer's transactions and dispositions of assets. In effect, such issuers have a statutory obligation to maintain proper internal books and records, in addition to any obligations relating to financial statements filed with the SEC or otherwise publicly disclosed.

In addition, issuers subject to the FCPA must adopt and maintain a system of internal accounting controls sufficient to provide reasonable assurances[318] that:

- transactions are executed in accordance with management's general or specific authorization;
- transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets;

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[317] "Foreign official" is defined to include officers or employees of public international organizations (*e.g.*, the World Bank and the United Nations). See Section 30A(f)(1)(A) of the 1934 Act. In addition, the FCPA also prohibits bribery of foreign political parties and candidates for foreign political office.

[318] The terms "reasonable detail" and "reasonable assurances" are defined to mean "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs." Section 13(b)(7) of the 1934 Act.

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- access to assets is permitted only in accordance with management's general or specific authorization; and
- the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.[319]

The FCPA accounting provisions are broad in scope. First, although the accounting provisions were added to the 1934 Act by the FCPA, the provisions are not limited to accounting for corrupt payments or bribes; rather, the FCPA's accounting provisions apply to all corporate activities. Second, the FCPA accounting provisions have no materiality element, and therefore, any mischaracterization or inaccuracy in an issuer's books and records, no matter how small, could constitute a violation. Third, the accounting provisions require issuers to ensure compliance by majority-owned subsidiaries. Accordingly, issuers are responsible for ensuring that their majority-owned subsidiaries maintain accurate books, records and accounts and implement adequate internal accounting controls.

Finally, for purposes of civil liability, there is no mens rea requirement (*i.e.*, no requirement of known or intentional violation of the FCPA), and thus, issuers may be held strictly liable for violations of the FCPA accounting provisions, including violations by their majority-owned subsidiaries. The accounting provisions may be criminally enforced for knowingly circumventing or knowingly failing to implement a system of internal accounting controls, or knowingly falsifying any book, record or account.[320]

FCPA Enforcement. The FCPA is enforced civilly by the SEC, which can obtain civil penalties, disgorgement and injunctive relief. The FCPA is also enforced criminally by the DOJ, which can obtain criminal fines and imprisonment. In November 2012, the Criminal Division of the Department of Justice and the Enforcement Division of the SEC released *A Resource Guide to the U.S. Foreign Corrupt Practices Act*.[321]

THE OFFICE OF FOREIGN ASSETS CONTROL ("OFAC")

Issuers organized under the laws of, or operating within, certain countries subject to U.S. economic sanctions may be prohibited from selling securities to U.S. investors by executive order of the President of the United States ("Executive Order"). The U.S.

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[319] Section 13(b)(2) of the 1934 Act.

[320] Section 13(b)(5) of the 1934 Act.

[321] See http://www.justice.gov/criminal/fraud/fcpa/guide.pdf. See also Sidley Austin LLP FCPA Update "DOJ and SEC Release Long Anticipated FCPA Guidance" (http://www.sidley.com/DOJ--SEC-Release-Long-Anticipated-FCPA-Guidance-11-15-2012/) and Sidley Austin LLP FCPA Update "The Top Ten Take-Aways from the DOJ" and SEC "Resource Guide to the U.S. Foreign Corrupt Practices Act" (http://www.sidley.com/The-Top-Ten-Take-Aways-from-the-DOJ-and-SEC-Resource-Guide-to-the-US-Foreign-Corrupt-Practices-Act-11-30-2012/).

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President is authorized to restrict trade with foreign countries under various statutes.[322] OFAC is authorized to adopt regulations to implement the Executive Orders in this regard. Under regulations adopted by OFAC and the U.S. Commerce Department's Bureau of Industry and Security and in force as of May 2013, trade and investment involving Burma (Myanmar), Cuba, Iran, Syria, North Korea and Sudan is restricted in varying degrees, absent an export license.[323] U.S. economic sanctions change frequently in response to evolving U.S. foreign policy considerations. Companies should consult OFAC's website for current rules. In addition, U.S. investors may not engage in transactions with entities that are either Specially Designated Nationals ("SDNs") identified on OFAC's SDN list or entities that are majority owned by SDNs but not separately identified on OFAC's SDN list.[324]

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[322] For example, such authorizations include the International Emergency Economic Powers Act of 1977, as amended, and the Trading with the Enemy Act of 1917, as amended.

[323] See http://www.treas.gov/offices/enforcement/ofac/programs/. The SDN list is available on the U.S. Treasury Department's web site at http://www.treas.gov/offices/enforcement/ofac/sdn/index.shtml and is periodically updated.

[324] For a brief discussion of OFAC in the context of U.S. banks, see Appendix E (*Regulation of Activities of U.S. Banks in the United States*) of this volume.

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SECTION IV. EXEMPT OFFERINGS, SECURITIES AND ISSUERS

Section IV examines the exemptions to the 1933 Act's registration requirements and exemptions from the requirement to register as an investment company under the 1940 Act.

The offering procedures necessary to establish an exemption from the 1933 Act's registration requirements differ depending on the exemption sought. Chapter 8 (*Exempt Offerings and Securities*) details the exemptions from registration under the 1933 Act that are available and the applicable offering procedures. Whether or not an offering is registered under the 1933 Act, the issuer should consider its status under the 1940 Act both before and after the offering. Chapter 9 (*1940 Act-Exempt Issuers*) explores various exemptions from the 1940 Act available to issuers.

Generally speaking, the U.S. offering process, including the disclosure and due diligence requirements, for a broadly-marketed Rule 144A offering (versus, for example, private placement to a limited group of investors that perform their own due diligence) of medium- or long-term fixed income securities or equity is substantially the same as the U.S. offering process for a 1933 Act-registered offering, but, in most cases, without the SEC's registration or ongoing compliance issues.

In certain cases, such as the issuance of securities by U.S. banks and U.S. branches of foreign banks, the exemption from having to register under the 1933 Act does not necessarily mean that no regulatory regime applies; rather, it means that a regulator other than the SEC may administer a registration process, as discussed, in the case of securities issued by banks, in Chapter 13 (*Bank Issuers*).

In many cases, however, the 1933 Act does not impose specific disclosure or registration requirements because the nature of the securities, such as commercial paper, or the nature of the investors, such as purchasers in traditional private placements pursuant to Section 4(a)(2) and Regulation D, or the nature of the issuers, such as the United States government or a state, municipality or agency, is such that prescribing a particular form of disclosure is not required. In those cases, the disclosure standards have developed to suit the market and are very much a product of custom and practice.

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CHAPTER 8

EXEMPT OFFERINGS AND SECURITIES

GENERAL 256
EXEMPT OFFERINGS UNDER THE 1933 ACT 256
EXEMPT SECURITIES UNDER THE 1933 ACT 279

GENERAL

There are many ways of offering securities in the U.S. capital markets without having to register the offering under the 1933 Act as discussed in Chapter 3 (*The Securities Registration and Reporting Process*). The offering itself may be made in a manner that does not require registration, which we call an "exempt offering," or the securities being offered may not be required to be registered, which we call "exempt securities."

In addition to discussing exempt offerings and exempt securities under the 1933 Act, in this chapter we also discuss (i) Title II of the JOBS Act, which requires the SEC to take action to amend rules under the 1933 Act to permit general solicitation or general advertising in connection with certain exempt offerings, (ii) Title III of the JOBS Act, which creates an exemption from registration intended to allow securities sales through crowdfunding, and (iii) Title IV of the JOBS Act, which raises the maximum amount of securities that may be sold in reliance on Section 3(b) of the 1933 Act to $50 million in any twelve-month period. On August 29, 2012, the SEC proposed amendments to Rule 506 under Regulation D and Rule 144A under the 1933 Act to implement Section 201(a) of Title II of the JOBS Act.[325] However, as of May 1, 2013, the SEC has not adopted final versions of those amendments or acted to implement or amend rules or regulations under the 1933 Act as required by Title III or Title IV of the JOBS Act.

EXEMPT OFFERINGS UNDER THE 1933 ACT

The two primary offering exemptions are Section 4(a)(2)[326] of the 1933 Act, which applies to private placements, and Regulation S under the 1933 Act, which applies to securities sold in offshore transactions to non-U.S. persons.

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[325] See SEC Release No. 33-9354 (Aug. 29, 2012) (the "2012 Rule 506 and Rule 144A Amendments Proposing Release") (http://www.sec.gov/rules/proposed/2012/33-9354.pdf).

[326] Due to the introduction of Section 4(b) of the 1933 Act by the JOBS Act, Section 4(2) of the 1933 Act was renumbered as Section 4(a)(2).

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Private Placements

Pursuant to Section 4(a)(2) of the 1933 Act, issuers may offer their securities without registration if those securities are privately placed in transactions that do not involve a public offering. Most private placements are structured to comply with one of two "safe harbors" that the SEC has adopted for conformity with Section 4(a)(2): either Regulation D or Rule 144A. As discussed below, as a result of the JOBS Act, Regulation D and Rule 144A are in the process of being amended.

Upon its enactment in April 2012, Title II of the JOBS Act directed the SEC to take action to, among other things:

- amend Rule 506 under Regulation D to provide that the prohibition against general solicitation and general advertising contained in Rule 502(c) under Regulation D shall not apply to offers and sales of securities under Rule 506, provided that (i) all purchasers of securities are accredited investors and (ii) the issuer takes reasonable steps to verify that such purchasers are accredited investors (using such verification methods as determined by the SEC); and

- amend Rule 144A to provide that securities sold under the exemption may be offered to persons other than qualified institutional buyers, including by means of general solicitation or general advertising, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer.

Pursuant to this directive, on August 29, 2012, the SEC proposed amendments to Rule 506 under Regulation D and Rule 144A to implement Section 201(a) of Title II of the JOBS Act. These proposed amendments are discussed in more detail under "Regulation D Private Placements" and "Rule 144A Offerings," respectively. However, as of May 1, 2013, the SEC has not adopted final versions of these amendments.

Because Rule 144A is an exemption that applies to resales, a Rule 144A offering usually is structured as a sale of the securities by the issuer to one or more broker-dealers (referred to as "initial purchasers" in the context of a Rule 144A offering) in a private placement pursuant to Section 4(a)(2) and an offering of the securities pursuant to Rule 144A by the initial purchasers to institutional investors that are "qualified institutional buyers" as defined in Rule 144A. Historically, the offering of the securities pursuant to Rule 144A has been private. However, as a result of the JOBS Act, Rule 144A will be amended to allow for securities sold under the exemption to be offered to persons other than qualified institutional buyers, including by means of general solicitation or general advertising, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer.

A Regulation D private placement typically refers to a traditional private placement either to a small group of institutional investors or to a combination of institutional and

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individual accredited investors.[327] As an alternative to Regulation D offerings, small offerings of securities can also be conducted under Regulation A.

Securities purchased in a private placement may not be publicly resold unless registered for resale under the 1933 Act or in transactions exempt from registration. The issuer and its financial intermediary must take reasonable care to ensure that purchasers are not acquiring the securities for the purpose of immediate distribution. This obligation may be satisfied by reasonable inquiry of the purchasers, written disclosure, investment letters signed by the purchaser and the use of a legend on certificates evidencing the securities. The appropriate procedures, however, will depend on the circumstances of the offering, the issuer and the securities offered.

It is important to remember that the relief from the general solicitation and general advertising prohibitions will not apply to Section 4(a)(2) offerings made outside Rule 506 under Regulation D or to private placements by persons other than the issuer. Private placements may be integrated with public offerings in certain circumstances, thus losing their status as a "private placement." The doctrine of integration is designed to prevent issuers from circumventing the 1933 Act registration requirements by, for example, conducting a public offering and, in an attempt to take advantage of increased investor interest, immediately making a private placement of substantially identical securities. Despite any position taken by the issuer that these are two separate offerings, the SEC might integrate the offerings and conclude that all of the securities had been offered pursuant to a general solicitation. Whether or not separate offerings of securities will be viewed as a single offering depends upon the particular facts and circumstances. Regulation D provides that offers and sales made more than six months before the commencement of a Regulation D offering or more than six months after the completion of a Regulation D offering will not be considered part of that offering, provided that, with certain exceptions, no offers or sales of similar securities are made by the issuer during that time period.

Rule 152 under the 1933 Act, as interpreted by the staff of the SEC, provides that the filing of a 1933 Act registration statement following an offering otherwise exempt under Section 4(a)(2) does not invalidate the Section 4(a)(2) exemption. Furthermore, depending upon the facts and circumstances, an offering that is truly private may be eligible for the Section 4(a)(2) exemption even though a 1933 Act registration statement was filed prior to the completion of the offering.[328] Commentary included in the SEC's 2007 proposals for amendments to Regulation D both confirmed these constructions of Rule 152 and expounded at some length on the circumstances under which simultaneous public and private offerings might be effected without integration.[329] Central to the SEC's analysis is the necessity that

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[327] See *Accessing the U.S. Capital Markets – Securities Products*.

[328] See, *e.g.*, SEC No-Action Letters Black Box Incorporated, available June 26, 1990, and Squadron Ellenoff, available Feb. 28, 1992.

[329] See SEC Release No. 33-8828 (Aug. 3, 2007) (the "2007 Regulation D Amendments Proposing Release") (http://www.sec.gov/rules/proposed/2007/33-8828.pdf) and the SEC Division of Corporation Finance's (continued)

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solicitation efforts in public and private offers be entirely separate. Where marketing efforts for the public offering are wholly distinct from solicitations for the private placement, the claim of exemption under Section 4(a)(2) will not depend on the status of the offerees in the unregistered offering as QIBs or institutional accredited investors.[330]

Regulation D Private Placements

Section 4(a)(2) of the 1933 Act exempts from the registration and prospectus delivery requirements "transactions by an issuer not involving any public offering." The procedures that an issuer must implement in order to establish the exemption vary depending upon the type of private placement. A private placement of long-term debt securities, for example, typically involves a limited number of institutional investors, normally only QIBs, and, therefore, requires less elaborate compliance procedures than other types of private placements. Private placements of limited partnership interests and other equity securities to sophisticated individuals and institutions, on the other hand, require more elaborate procedures. Private placements of commercial paper and medium-term notes typically require the issuer to consider the continuous or delayed offering features of the programs.[331]

Regulation D under the 1933 Act provides a set of non-exclusive guidelines (*i.e.*, a "safe harbor") for determining whether a private placement of securities qualifies for the Section 4(a)(2) exemption. Although issuers are not required to adhere to the guidelines set forth in Regulation D to establish a Section 3(b)[332] or Section 4(a)(2) exemption, most private placement offerings are patterned upon the general principles set forth in Regulation D. Any proposed variation from the guidelines should be reviewed with counsel to ensure that such variation would not require the offering to be registered under the 1933 Act. As previously noted, the relief from the general solicitation and general advertising prohibitions does not apply to Section 4(a)(2) offerings made outside Rule 506 under Regulation D. Therefore, such relief will not apply to offerings that are patterned upon, but do not adhere to, Rule 506.

Set forth below are general guidelines for issuers seeking to privately place securities pursuant to Regulation D.

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guidance in *Securities Act Sections Compliance and Disclosure Interpretations Question 139.25* (November 26, 2008) ("C&DI Question 139.25"). Although proposals to amend Regulation D pursuant to the 2007 Regulation D Amendments Proposing Release were abandoned by the SEC, the SEC staff has confirmed that the guidance presented in the 2007 Regulation D Amendments Proposing Release as well as C&DI Question 139.25 reliably represents its interpretation of integration issues.

[330] *Id.*

[331] Private placement procedures for commercial paper programs and medium-term note programs are discussed in *Accessing the U.S. Capital Markets – Securities Products*.

[332] Section 3(b) of the 1933 Act allows the SEC to exempt certain classes of securities by virtue of the small amount involved or the limited character of the public offering.

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General Solicitation or Advertising

Prior to the enactment of the JOBS Act, neither the issuer nor any person acting on its behalf (including selling agents) was permitted to offer or sell the securities by any form of general solicitation or general advertising. Title II of the JOBS Act directed the SEC to take action to amend Rule 506 under the 1933 Act to provide that the prohibition against general solicitation and general advertising contained in Rule 502(c) under the 1933 Act shall not apply to offers and sales of securities under Rule 506, provided that all purchasers of securities are accredited investors. In addition, the issuer will be required to "take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the [SEC]."[333]

Pursuant to the directive set forth in the JOBS Act, on August 29, 2012, the SEC proposed amendments to Rule 506 under Regulation D. Under a proposed new Rule 506(c), general solicitation and general advertising are expected to be permitted as long as the following conditions are satisfied:

- the issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors;
- all purchasers of securities must be accredited investors at the time of sale of the securities, either because such purchasers come within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they do; and
- all terms and conditions of Rule 501 and Rules 502(a) and 502(d) must be satisfied.

Whether the purchaser verification process is "reasonable" is expected to be an objective determination, based on the particular facts and circumstances of each transaction. In the 2012 Rule 506 and Rule 144A Amendments Proposing Release, the SEC highlighted the purpose of the verification process (*i.e.*, to address concerns, and reduce the risk, that the use of general solicitation and general advertising under Rule 506 may result in sales to investors who are not, in fact, accredited investors), but declined to establish uniform verification methods or even a non-exclusive list of specified methods for satisfying the verification requirement. Instead, issuers would need to consider a number of factors when determining the reasonableness of the steps to be taken to verify that a purchaser is an accredited investor. Examples of these factors include:

- the nature of the purchaser and the type of accredited investor that the purchaser claims to be;

[333] See Section 201(a)(1) of the JOBS Act.

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- the amount and type of information that the issuer has about the purchaser (including publicly available information in filings with a federal, state or local regulatory body or reasonably reliable third-party information); and

- the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.[334]

Any issuer claiming an exemption from the registration requirements of Section 5 of the 1933 Act has the burden of showing that it is entitled to that exemption. Therefore, regardless of the purchaser verification process, it will be important for issuers to retain adequate records that document the steps taken to verify that a purchaser was an accredited investor.

Securities acquired under proposed Rule 506(c) would be subject to the resale limitations under Rule 502(d) and would meet the definition of "restricted securities" under Rule 144(a)(3)(i). Notwithstanding proposed new Rule 506(c), issuers alternatively will continue to be able to conduct Rule 506 offerings without the use of general solicitation or general advertising as they had prior to the proposed amendments.

As discussed below under "—Number and Nature of Purchasers," under Rule 506(b), an issuer may sell its securities to an unlimited number of accredited investors, but there may be no more than (or the issuer must reasonably believe that there are no more than) thirty-five other non-accredited investors. The ban on general solicitation and general advertising would still apply for private placements by issuers where investors other than accredited investors (or investors that the issuer does not believe are accredited investors) ultimately purchase securities sold in the private placement. Therefore, if there is any expectation that purchases of an issuer's securities will be made by one or more investors that are not

[334] In the 2012 Rule 506 and Rule 144A Amendments Proposing Release, the SEC observed that the steps that may be reasonable to verify that an entity is an accredited investor by virtue of being a registered broker-dealer (*e.g.*, by checking the entity's name against information on FINRA's BrokerCheck website) would differ from the steps that would be reasonable to verify whether a natural person is an accredited investor. Further, the SEC added that an issuer that solicits new investors through a website accessible to the general public or through a widely disseminated email or social media solicitation would likely be obligated to take greater measures to verify accredited investor status than an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party. (In the case of the former type of solicitation, the SEC made clear that it does not believe that an issuer would have taken reasonable steps to verify accredited investor status if, absent other information about the purchaser that indicated accredited investor status, the issuer required only that the purchaser check a box in a questionnaire or sign a form.) In addition, the SEC acknowledged that there is merit to the view that the ability of a purchaser to satisfy a minimum investment amount requirement that is sufficiently high such that only accredited investors could reasonably be expected to meet it (with a direct cash investment that is not financed by the issuer or by any other third party), could be taken into consideration in verifying accredited investor status.

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accredited investors, neither the issuer nor any person acting on its behalf may offer or sell the securities by any form of general solicitation or general advertising.[335]

Number and Nature of Purchasers

Regulation D does not limit the number of accredited investors who may purchase the securities, but Rule 505 and Rule 506 limit the number of non-accredited investors to thirty-five. The term "accredited investors"[336] is defined to include banks, insurance companies, registered and small business investment companies, certain business development companies, certain employee benefit plans, organizations with total assets in excess of $5 million and certain high net worth/net income individuals.

For suitability and state securities law reasons, private placements under Regulation D are often limited to "institutional accredited investors," that is, those categories identified above except for natural persons.

Information Requirements

If the securities are sold only to accredited investors, Regulation D does not require the issuer to provide investors with specific information. Investors in private placements are typically limited to accredited investors. Even if a private placement is limited to accredited investors, however, a private placement memorandum will usually be prepared and circulated to prospective purchasers, both for marketing reasons and to reduce the potential liabilities of participants in the offering. Where non-accredited investors are involved, Regulation D provides guidelines for disclosure that vary depending upon (a) whether the issuer is or is not a reporting company under the 1934 Act and (b) the dollar value of the securities offered.

In connection with Rule 144A offerings and other securities being privately placed by companies that file reports under the 1934 Act, issuers and securities firms frequently seek to maintain the same disclosure standards as those required for 1933 Act-registered offerings of

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[335] In the 2012 Rule 506 and Rule 144A Amendments Proposing Release, the SEC acknowledged that offerings under Rule 506 (as now in effect) represent an important source of capital for issuers of all sizes and stated that it believed that the continued availability of Rule 506 in effect will be important for those issuers that either do not wish to engage in general solicitation or general advertising in their Rule 506 offering (and become subject to the new requirement to take reasonable steps to verify the accredit investor status of purchasers) or wish to sell privately to non-accredited investors who meet Rule 506(b)'s sophistication requirements. Consistent with prior guidance, the SEC also stated that retaining the safe harbor under Rule 506 (as now in effect) may also be beneficial to investors with whom an issuer has a pre-existing substantive relationship. Thus, the proposed amendments to Rule 506 would not amend or modify the requirements relating to existing Rule 506.

[336] Key terms, such as "accredited investor," are defined in Rule 501 under Regulation D. In December 2011, to implement the requirements of Section 413(a) of the Dodd-Frank Act, the SEC amended its rules to exclude the value of a natural person primary residence (and, with certain exceptions, indebtedness secured by such primary residence) from the net worth calculations used to determine whether an individual is an "accredited investor."

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the same security.[337] As a result, the SEC disclosure rules for 1933 Act-registered offerings often serve as a disclosure guide for private placements. It is important to remember that Section 4(a)(2) (and likewise the Regulation D and Rule 144A safe harbors) only exempt offerings from the registration requirements of the 1933 Act (and from certain statutory liabilities related to the filing of registration statements). It does not exempt offerings from federal or state anti-fraud or civil liability laws.

Regulation D also requires the issuer to provide potential investors, for a reasonable time prior to the sale of its securities, the opportunity to ask questions and receive answers concerning the terms and conditions of the offering and to obtain any additional information that the issuer possesses or can acquire without unreasonable effort or expense. While this obligation represents a standard undertaking in private placement disclosure documents, except where the offering is a limited placement to only a few institutional investors, it is unlikely that an issuer will be subject to any burdensome questions from potential investors.

Notice Requirements

If the offering is made pursuant to Regulation D, the issuer must make a Form D filing with the SEC within fifteen days of the first sale of securities in the offering. The SEC in 2008 adopted rules requiring electronic filings for all Form D filings on or after March 16, 2009.[338]

Because Regulation D is only a "safe harbor" for complying with Section 3(b) or Section 4(a)(2) (*i.e.*, it is not the exclusive means for ensuring that a public distribution has not been made), issuers sometimes do not file Form D in reliance upon counsel's opinion that, in light of all of the facts and circumstances of the offering, the offering will be exempt from registration under Section 4(a)(2) despite the failure to file the form. As previously noted, however, the relief from the general solicitation and general advertising prohibitions does not apply to Section 4(a)(2) offerings made outside Rule 506 under Regulation D. Therefore, issuers using general solicitation or general advertising in connection with a

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[337] By contrast, traditional private placements by private companies are often undertaken on the basis of disclosure documents that are substantially less comprehensive than would be required for a 1933 Act-registered offering, so long as the offering is limited to sophisticated investors, such as insurance companies and other institutional investors, that are capable of performing their own due diligence investigation.

[338] See SEC Release No. 33-8891 (Feb. 6, 2008) (http://www.sec.gov/rules/final/2008/33-8891.pdf). The SEC found it necessary to include a safe harbor from the "general solicitation" prohibition for a Form D filed with the SEC where the information is provided in good faith and the issuing company makes reasonable efforts to comply with Regulation D.

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private placement will need to adhere to proposed Rule 506(c), which includes the requirement to make a timely Form D filing.[339]

Aggregate Offering Price

Rule 504 of Regulation D provides a safe harbor Section 3(b) exemption for sales of securities not exceeding an aggregate offering price of $1 million so long as the issuer is not a reporting company under the 1934 Act, an investment company or a blank check company. Similarly, Rule 505 of Regulation D, which also provides a Section 3(b) exemption, limits the aggregate offering price to $5 million. The calculation of the maximum aggregate offering price under both rules is reduced by the aggregate offering price for Section 3(b) exempt securities sold in the previous twelve months. For example, if an issuer sells $850,000 aggregate offering price of securities on March 20th under a Section 3(b) exemption, a second offering under Rule 504 would be limited to $150,000 until March 20th of the following year. Rule 506, on the other hand, is a Section 4(a)(2) exemption and does not limit the maximum aggregate offering price.

As an alternative to a Rule 504 or 505 offering, Regulation A provides a safe-harbor Section 3(b) exemption for small issues of securities. Regulation A, like Rule 505, limits the maximum aggregate offering price to $5 million, less the aggregate offering price of securities sold in the previous twelve months. The $5 million limitation under Regulation A, however, is only reduced by prior offerings in reliance on Regulation A, whereas Rule 505's maximum limit is reduced by all Section 3(b) exempt offerings. Another attractive feature of Regulation A, as opposed to Rule 504 or 505, is that the issuer is not prohibited from using forms of general solicitation or advertising to sell securities. This allows small issuers who do not have a previous relationship with investors to be able to more quickly and more easily raise capital.

Regulation A also provides greater protection against integration with other offerings than does Regulation D. Offerings made under Regulation A are not integrated with prior transactions as long as those transactions have been completed before the commencement of the Regulation A offering. Additionally, Regulation A provides "double-sided" protection against integration with other specified future offerings. This means that not only is the future non-Regulation A offering not integrated into the Regulation A offering, but that the Regulation A offering will not be integrated into the other offering.

Under Section 401 of the JOBS Act, the SEC is required to issue rules or regulations to add a new securities registration exemption, similar to Regulation A, that is to allow the public offering, without registration, of up to $50 million aggregate offering amount of the following securities within any twelve-month period: equity securities; debt securities; and

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[339] In connection with the proposed Rule 506 amendments relating to the elimination of the prohibition on general solicitation and general advertising, the SEC proposed to amend Form D to add a separate check box for issuers to indicate whether they are claiming an exemption under proposed Rule 506(c).

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debt securities convertible or exchangeable to equity interests, including any guarantees of such securities. These securities will not be treated as restricted securities under Rule 144. Investors may be solicited before any offering statement required by rule (which may be required to include the issuer's audited financial statements as well as a description of the issuer's business operations, financial condition, corporate governance principles, use of investor funds and other appropriate matters) must be filed. Issuers relying on this proposed exemption will be required to file financial statements annually with the SEC and may be subject to such additional periodic disclosure requirements as the SEC may require. The SEC is also authorized to impose disqualification provisions, similar to those set forth in the regulations adopted in accordance with Section 926 of the Dodd-Frank Act, prohibiting the use of the exemption by certain issuers and their predecessors, affiliates, officers, directors, underwriters and other related persons. It appears that securities sold in reliance on this proposed exemption will not be exempt from registration requirements under state laws unless such securities are offered and sold on a national securities exchange or offered or sold to a qualified purchaser, as defined by the SEC pursuant to Section 18(b)(3) of the 1933 Act with respect to that purchase or sale. The JOBS Act does not impose a deadline for the rules the SEC is required to adopt, and as of May 1, 2013, the SEC has not indicated when it will be adopting such rules.

Rule 144A Offerings

Rule 144A is technically a resale exemption for buyers of restricted securities. It only permits persons *other than the issuer* to resell securities. Historically, such resale has only been allowed in a transaction not involving a public offering. However, Title II of the JOBS Act directed the SEC to amend Rule 144A to provide that securities sold under the exemption may be offered to persons other than qualified institutional buyers, including by means of general solicitation or general advertising, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer.[340] QIBs include, for example, specified institutions that in the aggregate own and invest at least $100 million of specified types of securities[341] and dealers that own and invest in at least $10 million of those types of securities (excluding unsold allotments of public offerings).

Pursuant to the directive set forth in the JOBS Act, on August 29, 2012, the SEC proposed amendments to Rule 144A(d)(1) to eliminate the references to "offer" and "offeree."[342] Under the proposed amendment to Rule 144A(d)(1), securities are only

[340] Section 201(a)(2) of the JOBS Act.

[341] In determining the aggregate amount of securities owned, an investor or dealer must exclude bank deposit notes, certificates of deposit, loan participations, repurchase agreements and securities owned but subject to repurchase agreements and currency, interest rate and commodity swaps.

[342] Currently, Rule 144A(d)(1) states: "The securities are offered or sold only to a qualified institutional buyer or to an offeree or purchaser that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer."

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required to be sold to a QIB or to a purchaser that the seller and any person acting on behalf of the seller reasonably believe is a QIB. Thus, under this proposed amendment, resales of securities pursuant to Rule 144A could be conducted using general solicitation and general advertising, so long as the purchasers are limited in this manner.

Securities offered pursuant to Rule 144A may not, when issued, be of the same class as securities listed on a U.S. securities exchange or automatic quotation system. Securities convertible or exchangeable into a class of underlying securities that at the time of issuance are listed on a U.S. securities exchange may not be sold in reliance on Rule 144A unless the effective conversion premium or exercise price is at least 10%. In the case of mandatorily exchangeable securities,[343] however, the offer and sale of such mandatorily exchangeable securities has been interpreted by the SEC staff to be a contemporaneous offer and sale of the underlying security, and the minimum effective conversion premium exception is not available. Thus, if the specific underlying security is listed on a U.S. securities exchange or automatic quotation system, Rule 144A is not available. However, the SEC staff has taken the position that Rule 144A eligibility of a specific underlying security is not affected if the specific underlying security is of a class that is listed or quoted on a securities exchange or automatic quotation system subsequent to the issuance of the specific underlying security. Therefore, the listing or quotation of a class of securities that is of the same class as a security underlying a mandatorily exchangeable security will not cause either the mandatorily exchangeable security or the underlying security to be ineligible for resale pursuant to Rule 144A if the issuance of the specific underlying security predates the listing or quotation of such class.[344]

Unless the issuer of securities offered pursuant to Rule 144A is subject to 1934 Act reporting requirements or, in the case of a foreign private issuer, exempt from those requirements pursuant to Rule 12g3-2(b),[345] the issuer must agree to provide certain limited information about its business and financial condition to holders of the securities and to prospective purchasers designated by the holders so long as the securities remain subject to Rule 144A transfer restrictions.

There are two types of Rule 144A offerings: Rule 144A-only offerings and Rule 144A-eligible offerings. These two types of offerings differ with respect to how privately-placed securities may be resold.

Rule 144A-only offerings generally provide that any resale in the U.S. capital markets of the securities may only be made pursuant to Rule 144A (until the securities become freely

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[343] Mandatorily exchangeable securities are securities that by their terms automatically exchange or convert into the underlying securities.

[344] SEC No-Action Letter, Shearman & Sterling, available December 21, 1998.

[345] For more discussion of the application of Rule 12g3-2(b) to non-U.S. concerns, see "Information Reporting under Rule 12g3-2(b) for Foreign Private Issuers" in Chapter 3 (*The Securities Registration and Reporting Process*) of *Accessing the U.S. Capital Markets – Non-U.S. Issuers*.

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tradable under Rule 144 or are registered under the 1933 Act). In addition, 144A-only offerings usually require that QIBs be the initial purchasers of the securities.

Rule 144A-eligible offerings are drafted to permit resales in the U.S. capital markets in accordance with Rule 144A. However, unlike the Rule 144A-only offerings, resales of securities in the U.S. capital markets in a Rule 144A-eligible offering may be made pursuant to some or all of the other available 1933 Act exemptions as well (*e.g.*, "Section 4(1½)").

Regulation S Offerings

Regulation S is not technically an "exemption" from the 1933 Act registration requirements. Regulation S provides safe-harbor guidelines for determining when an offering of securities will be deemed to have occurred outside the United States and, therefore, not be subject to registration under the 1933 Act. Regulation S contains one safe harbor that applies to transactions by issuers and distributors (generally underwriters of securities) and another safe harbor that applies to resales. Both safe harbors require (1) the presence of an offshore transaction, (2) the absence of directed selling efforts in the United States and (3) sales only to non-U.S. persons.[346] In addition, depending on the category of securities (as discussed below), other requirements must be satisfied.

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[346] A "U.S. person" means: (i) any natural person resident in the United States; (ii) any partnership or corporation organized or incorporated under the laws of the United States; (iii) any estate of which any executor or administrator is a U.S. person; (iv) any trust of which any trustee is a U.S. person; (v) any agency or branch of a foreign entity located in the United States; (vi) any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person; (vii) any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated, or (if an individual) resident in the United States; and (viii) any partnership or corporation if: (A) organized or incorporated under the laws of any foreign jurisdiction; and (B) formed by a U.S. person principally for the purpose of investing in securities not registered under the 1933 Act, unless it is organized or incorporated, and owned, by accredited investors (as defined in Rule 501(a) under the 1933 Act) who are not natural persons, estates or trusts.

The following are not "U.S. persons": (i) any discretionary account or similar account (other than an estate or trust) held for the benefit or account of a non-U.S. person by a dealer or other professional fiduciary organized, incorporated, or (if an individual) resident in the United States; (ii) any estate of which any professional fiduciary acting as executor or administrator is a U.S. person if: (A) an executor or administrator of the estate who is not a U.S. person has sole or shared investment discretion with respect to the assets of the estate; and (B) the estate is governed by foreign law; (iii) any trust of which any professional fiduciary acting as trustee is a U.S. person, if a trustee who is not a U.S. person has sole or shared investment discretion with respect to the trust assets, and no beneficiary of the trust (and no settlor if the trust is revocable) is a U.S. person; (iv) an employee benefit plan established and administered in accordance with the law of a country other than the United States and customary practices and documentation of such country; (v) any agency or branch of a U.S. person located outside the United States if: (A) the agency or branch operates for valid business reasons; and (B) the agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located; and (vi) the International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian
(continued)

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Offers or sales of securities are considered "offshore transactions" when two conditions are satisfied. First, the offer must be made to a person outside the United States other than a distributor. Second, at the time the buy order is originated, the buyer must be outside the United States or the seller and any person acting on his behalf must reasonably believe the buyer is outside the United States. The second condition can also be met for the purposes of the safe harbor for issuer and distributor transactions if the transaction is executed through a physical trading floor of an established foreign securities exchange located outside the United States.

"Directed selling efforts" are defined as activities undertaken for the purpose of conditioning the U.S. market for any of the securities being offered in reliance on Regulation S. Activities that could reasonably be expected to have this conditioning effect are also considered directed selling efforts. Common problems arising under this definition of directed selling efforts relate to advertising, foreign press-related activity, quotation services, Internet postings and research.

The safe harbor for issuers and distributors is comprised of three different exemptions from the registration requirements that are based on factors such as (1) the jurisdiction of incorporation of the issuer, (2) the issuer's reporting status under the 1934 Act and (3) the degree of U.S. market interest in the issuer's securities. Offshore transactions that comply with Regulation S will not be integrated with registered offerings in the United States or with offerings that qualify for an exemption under the 1933 Act, such as Rule 144A offerings, even if such offerings are undertaken simultaneously.[347] However, Regulation S is not available with respect to any transaction or series of transactions that constitute a scheme to evade the registration requirements of the 1933 Act.

In addition to (i) satisfying the offshore transaction requirement and the prohibition on directed selling efforts and (ii) limiting sales to non-U.S. persons, other requirements may apply depending on the "category" of securities being offered. The applicable category is determined at the time the issuer makes the offshore offering. If, after the offering is made, changes occur in the issuer's circumstances that would permit it to qualify for a different category of the safe harbor in the future, there will be no change in any distribution

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Development Bank, the African Development Bank, the United Nations, and their agencies, affiliates and pension plans, and any other similar international organizations, their agencies, affiliates and pension plans.

[347] The 2012 Rule 506 and Rule 144A Amendments Proposing Release confirmed that, consistent with the historical treatment of concurrent Regulation S and Rule 144A/Rule 506 offerings, concurrent offshore offerings that are conducted in compliance with Regulation S would not be integrated with domestic unregistered offerings that are conducted in compliance with Rule 506 or Rule 144A, as proposed to be amended.

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compliance period (discussed below) for the outstanding securities issued under the prior category.[348]

Category 1

No additional requirements apply to Category 1 securities, which include:

- securities offered by a non-U.S. issuer who reasonably believes at the commencement of the offering that there is no "substantial U.S. market interest"[349] in the securities offered;
- securities offered and sold in an "overseas directed offering";[350]

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[348] See the SEC Division of Corporation Finance's guidance in *Securities Act Rules Compliance and Disclosure Interpretations Question 277.01* (January 26, 2009).

[349] (1) "Substantial U.S. market interest" or "SUSMI" with respect to a class of an issuer's equity securities means: (i) the securities exchanges and inter-dealer quotation systems in the United States in the aggregate constituted the single largest market for such class of securities in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation; or (ii) 20% or more of all trading in such class of securities took place in, on or through the facilities of securities exchanges and inter-dealer quotation systems in the United States and less than 55% of such trading took place in, on or through the facilities of securities markets of a single foreign country in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation.

(2) "Substantial U.S. market interest" with respect to an issuer's debt securities means: (i) its debt securities, in the aggregate, are held of record (as that term is defined in Rule 12g5-1 under the 1934 Act and used for purposes of this paragraph (2)) by 300 or more U.S. persons; (ii) $1 billion or more of: the principal amount outstanding of its debt securities, the greater of liquidation preference or par value of its securities described in Rule 902(a)(1) under the 1933 Act, and the principal amount or principal balance of its securities described in Rule 902(a)(2) under the 1933 Act, in the aggregate, is held of record by U.S. persons; and (iii) 20% or more of: the principal amount outstanding of its debt securities, the greater of liquidation preference or par value of its securities described in Rule 902(a)(1) under the 1933 Act, and the principal amount or principal balance of its securities described in Rule 902(a)(2) under the 1933 Act, in the aggregate, is held of record by U.S. persons.

(3) Notwithstanding paragraph (2) above, substantial U.S. market interest with respect to an issuer's debt securities is calculated without reference to securities that qualify for the commercial paper exemption provided by Section 3(a)(3) of the 1933 Act.

[350] An "overseas directed offering" means (i) an offering of securities of a non-U.S. issuer that is directed into a single country other than the United States to the residents thereof and that is made in accordance with the local laws and customary practices and documentation of such country; or (ii) an offering of non-convertible debt securities of a domestic issuer that is directed into a single country other than the United States to the residents thereof and that is made in accordance with the local laws and customary practices and documentation of such country, provided that the principal and interest of the securities (or par value, as applicable) are denominated in a currency other than U.S. dollars and such securities are neither convertible into U.S. dollar-denominated securities nor linked to U.S. dollars (other than through related currency or interest rate swap transactions that are commercial in nature) in a manner that in effect converts the securities to U.S. dollar-denominated securities.

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- 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 non-U.S. jurisdiction.

Category 1 does not contemplate any distribution compliance period during which the offering is subject to the offering restrictions discussed below for Category 2 and Category 3. Out of an abundance of caution, however, some participants in Category 1 transactions impose a forty-day distribution compliance period as a prophylactic measure, particularly where there is a 144A component and, in the case of a continuous offering program, the issuer intends to increase U.S. interest in its securities.

Category 2

Category 2 applies to securities that are not eligible for Category 1 and that are either (a) equity securities of a non-U.S. issuer that is a reporting company under the 1934 Act or (b) debt securities of (i) a reporting issuer (U.S. or non-U.S.) or (ii) a non-reporting non-U.S. issuer. Issuers of Category 2 securities may take advantage of the safe harbor if they satisfy the following conditions:

- Certain "offering restrictions" must be implemented in addition to the general Regulation S requirements, including:
  - each distributor must agree in writing that (i) all offers and sales during a forty-day distribution compliance period[351] may be made only in accordance with safe harbors under Regulation S, pursuant to registration under the 1933 Act or pursuant to an exemption from such registration and (ii) for offers and sales of equity securities of U.S. issuers, not to engage in hedging transactions with regard to such securities during the forty-day distribution compliance period, unless in compliance with the 1933 Act; and
  - all offering materials and documents (other than press releases, and including advertisements) used in connection with offers and sales during the forty-day distribution compliance period must (i) disclose that the securities are not registered under the 1933 Act and cannot be sold in the United States or to U.S. persons (as defined in Regulation S) (other than distributors) unless the

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[351] The forty-day distribution compliance period begins on the later of the date of the closing for the securities being offered or the date on which securities were first offered to persons other than distributors (generally, the pricing date). However, in a continuous offering the forty-day distribution compliance period begins on the date of the completion of distribution, as determined and certified by the managing underwriter or lead dealer. The distribution compliance period is a requirement distinct from the forty-day "restricted period" required under U.S. Department of the Treasury regulations under the Tax Equity and Fiscal Responsibility Act of 1982 for bearer instruments, although the periods often overlap. For a discussion of the "restricted period," see *Accessing the U.S. Capital Markets – Securities Products.*

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securities are registered under the 1933 Act or an exemption from registration is available and (ii) in the case of offers and sales of equity securities of U.S. issuers, state that hedging transactions involving those securities may not be conducted unless in compliance with the 1933 Act.

- During the forty-day distribution compliance period, offers and sales of the security cannot be made to a U.S. person other than a distributor;[352] and

- Each distributor selling securities during the forty-day distribution compliance period to another distributor, dealer, or person receiving a selling concession or fee must send a confirmation or other notice to the purchaser stating that the purchaser is subject to the same restriction on offers and sales as the distributor.

Category 3

Category 3 securities include all securities that are not eligible for Category 1 or 2, such as debt or equity securities of a non-reporting U.S. issuer. In addition to the general Regulation S requirements, the issuer must satisfy the following conditions:

- Each of the offering restrictions discussed above for Category 2 securities must be met, except that a six-month distribution compliance period (one year if the issuer does not file 1934 Act reports with the SEC) applies to offerings of equity securities and a forty-day distribution compliance period applies to offerings of debt securities.[353]

- During the applicable distribution compliance period, offers or sales cannot be made to a U.S. person other than a distributor.[354]

- Equity securities may be sold prior to the expiration of a six-month distribution compliance period (one year if the issuer does not file 1934 Act reports with the SEC) so long as the following conditions are satisfied:

    - the purchaser (other than a distributor) certifies that it is not a U.S. person or is a U.S. person who purchased the securities in an exempt transaction under the 1933 Act;

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[352] As discussed above, exempt sales to U.S. persons during the distribution compliance period are permissible and will not be integrated with the Regulation S offering.

[353] "Equity securities" are defined in Rule 405 under the 1933 Act and include debt securities that are convertible into equity securities. Regulation S defines "debt securities" to include certain non-participating preferred stock and asset-backed securities.

[354] See *supra* note 351.

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  - o the purchaser agrees to resell the securities only in accordance with Regulation S or pursuant to registration under the 1933 Act or an exemption from such registration, and agrees not to engage in hedging transactions with regard to the securities unless in compliance with the 1933 Act; and

  - o certain other restrictions are satisfied, including a prohibition against corporate registration of transfers not made in accordance with Regulation S.

- Debt securities generally must be represented upon issuance by a temporary global security not exchangeable for definitive securities until the expiration of the forty-day distribution compliance period and, for persons other than distributors, until certification of beneficial ownership by a non-U.S. person or a U.S. person who purchased the securities in an exempt transaction under the 1933 Act.[355]

- Any distributor selling the securities during the applicable distribution compliance period to another distributor, dealer, or person receiving a selling concession or fee must send a notice or confirmation to the purchaser stating that the purchaser is subject to the same restrictions on offers and sales as the distributor.

Crowdfunding

Once SEC rulemaking has been completed, new Section 4(a)(6) of the 1933 Act will allow certain issuers[356] to make unregistered offers and sales of up to $1 million aggregate amount of its securities in any twelve-month period. Sales to any single investor during the twelve-month period must be limited to (i) the greater of $2,000 or 5% of the investor's annual income or net worth if either measure is less than $100,000 and (ii) up to 10% of the investor's annual income or net worth, up to a maximum of $100,000, if either the annual income or net worth of the investor is $100,000 or more. An issuer relying on Section 4(a)(6) will be required to file with the SEC, and to provide to intermediaries, numerous disclosures prescribed by Section 4A(b) concerning the issuer, its principals and its business and financial condition (including, in certain cases, audited financial statements), among other matters.

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[355] There has been considerable difficulty in getting the European clearing systems to accept temporary global securities for securities in registered form as opposed to bearer form. This problem is exacerbated when the securities have a short tenor (*i.e.,* less than one year).

[356] For example, such issuers do not include: foreign issuers; issuers that are subject to the requirement to file reports pursuant to Section 13 or Section 15(d) of the 1934 Act; and issuers that are investment companies as defined in Section 3 of the 1940 Act or are excluded from such definition by Section 3(b) or 3(c) of the 1940 Act. Disqualification provisions will also render certain issuers unable to make offers and sales pursuant to Section 4(a)(6) of the 1933 Act.

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Sales in reliance on Section 4(a)(6) must be made "through" a registered broker or funding portal otherwise satisfying the disclosure and sales practice conditions of new Section 4A(a). "Funding portal" is a new term describing a party acting as an intermediary solely in Section 4(a)(6) offerings and refraining from certain other investment-related conduct. An eligible funding portal will be required to register with the SEC and FINRA and to undertake substantial responsibility for investor education and risk awareness. Unregistered transfers of securities sold under Section 4(a)(6) will be prohibited during the one-year period beginning on the date of purchase, except for sales to the issuer or to an accredited investor and for certain family transfers. Investors in Section 4(a)(6) securities will not be counted as record holders for purposes of 1934 Act registration requirements. Issuers relying on the exemption will be exposed to liability for material misstatements and omissions of fact, which will be independently actionable against sellers under Section 12(a)(2), subject to a defense of reasonable care. Registration requirements under state law will be preempted for securities sold in reliance on Section 4(a)(6). The SEC is required to adopt implementing regulations within 270 days of enactment of the JOBS Act. As of May 1, 2013, the SEC had not implemented any such regulations.

Resales of Securities Sold in Exempt Offerings

While securities that have been registered under the 1933 Act may be freely resold by investors without re-registration,[357] securities sold pursuant to an exemption may be resold only if subsequently registered for resale under the 1933 Act or if resold pursuant to an available exemption. Discussed below are available 1933 Act registration methods and 1933 Act exemptions for secondary market transactions involving unregistered securities.

Registration Rights

In many private placements, investors are given the right to have the securities they acquire registered for resale under the 1933 Act. Registration rights are normally afforded under a separate agreement between the issuer and the initial investors known as a registration rights agreement. Registration rights have been popular in fixed-income and convertible securities Rule 144A offerings by 1934 Act reporting companies as they enable issuers to tap the capital markets quickly and opportunistically while avoiding, at the time of the offering, the delay and uncertainties of the SEC registration process. Purchasers of equity and convertible securities privately placed by private companies may also receive registration rights.

There are four general categories of registration rights: demand registration rights, "piggy-back" registration rights, shelf registration rights and exchange rights. Demand registration rights provide investors with the right to require registration of the securities at

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[357] This is true so long as the seller is not affiliated with the issuer. See the further discussion below under the heading "Exempt Offerings under the 1933 Act—Regulation S Offerings—Resales of Securities Sold in Exempt Offerings—Resales by Control Persons."

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the issuer's expense. Piggy-back registration rights provide investors with the right to register their securities whenever the issuer files a registration statement covering securities of the same class. Shelf registration rights require the issuer to register the privately-placed securities under a shelf registration statement pursuant to Rule 415[358] for sale from time to time in so-called "uncoordinated distributions."

Exchange rights provide investors with the right to surrender the privately-placed, restricted securities with such rights to the issuer in exchange for identical, newly issued securities that have been registered under the 1933 Act. Pursuant to a series of no-action letters, the newly issued, 1933 Act-registered securities received by investors in the exchange are freely tradable, so long as the investors acquire the new securities in the ordinary course of business and are not participating in the distribution of those securities.[359] However, with respect to U.S. issuers, these no-action letters have generally been limited to exchanges of non-convertible debt securities and non-convertible preferred stock, with the result that exchange rights are not available for common stock and functionally equivalent securities of U.S. issuers, such as debt securities convertible into common stock.

Registration rights continue to be popular with investors, particularly where book-entry securities are involved, despite the adoption of amendments to Rule 144 in February 2008 (discussed below) that reduced the minimum holding period prior to privately-placed securities becoming freely tradable from two years to one year or six months. This is primarily due to the difficulty currently involved in converting a CUSIP number, and therefore a DTC trading position, from a restricted or "private" trading position to a freely-tradable trading position.

Resales by Control Persons

Resales of securities, even if registered, present unique concerns for control persons of issuers. Generally, "control persons" (*i.e.*, affiliates) of the issuer include those who have

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[358] See Chapter 5 (*Shelf Registration*).

[359] These exchange offers are called "Exxon Capital" exchange offers after the first SEC no-action letter that approved the technique. See SEC No-Action Letter Exxon Capital Holdings Corp., available May 13, 1988. Other significant SEC No-Action Letters include: Vitro, Sociedad Anonima, available November 19, 1991, Corimon C.A. S.A.C.A., available March 22, 1993 and Espírito Santo Financial Holding S.A., available June 30, 1993 (Rule 144A and/or Regulation S ADRs or GDRs); Epic Properties, Inc., available October 21, 1991 (mortgage notes); Warnaco, Inc., available October 11, 1991 (discount notes); Morgan Stanley & Co. Incorporated, available June 5, 1991 (any debt security, investment grade-rated preferred stock or substantially similar security that is not convertible into or exchangeable for any equity security other than preferred stock); Mary Kay Cosmetics, Inc., available June 5, 1991 (guaranteed senior notes); and K-III Communications Corp., available May 14, 1993 (non-rated preferred stock exchangeable for subordinated debt securities). In another no-action letter, the SEC imposed conditions on a broker-dealer's participation in an issuer's registered exchange offer. See SEC No-Action Letter Shearman & Sterling, available July 2, 1993. The SEC also has confirmed this position with respect to exchanges of capital securities. See SEC No-Action Letter Brown & Wood LLP, available February 7, 1997.

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the power to compel registration of the issuer's securities or have the ability to direct management and business policies of the issuer.

As a general matter, any resale of a security must be registered under the 1933 Act unless an exemption from registration is available. Investors who purchase securities in the open market typically rely on the exemption available under Section 4(a)(1) of the 1933 Act, which provides that securities sold in transactions not involving an "underwriter" need not be registered. However, the 1933 Act defines an "underwriter" as someone who purchases securities from an "issuer" with a view to the distribution of those securities and, for this purpose, defines an "issuer" as including a control person of the issuer. Accordingly, any time that a control person of an issuer resells that issuer's securities, (i) the control person will be deemed an "issuer," (ii) the person who acquires those securities will be deemed an "underwriter" if they purchase with a view to distribution of the securities and (iii) the exemption that ordinarily would have been available under Section 4(a)(1) of the 1933 Act for transactions not involving an "underwriter" will not be available. As a result, each resale of an issuer's securities by a control person, regardless of whether the control person acquired those securities in a private placement or in the open market, must be registered under the 1933 Act or must be made pursuant to an available exemption from registration, such as Rule 144 and Rule 144A.

Rule 144

Rule 144 under the 1933 Act generally permits public resales of restricted securities[360] without registration under the 1933 Act commencing six months after the date such securities are purchased from the issuer or an affiliate of the issuer (in the case of an

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[360] The term "restricted securities" is defined under Rule 144 under the 1933 Act to mean:

(1) Securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering;

(2) Securities acquired from the issuer that are subject to resale limitations of Rule 502(d) or Rule 701(c) under the 1933 Act;

(3) Securities acquired in a transaction or chain of transactions meeting the requirements of Rule 144A;

(4) Securities acquired from the issuer in a transaction subject to the conditions of Regulation CE;

(5) Equity securities of U.S. issuers acquired in a transaction or chain of transactions subject to the conditions of Rule 901 or Rule 903 under Regulation S;

(6) Securities acquired in a transaction made under Rule 801 under the 1933 Act to the same extent and proportion that the securities held by the securityholder of the class with respect to which the rights offering was made were, as of the record date of the rights offering, "restricted securities":

(7) Securities acquired in a transaction made under Rule 802 under the 1933 Act to the same extent and proportion that the securities were tendered or exchanged in the exchange offer or business combination were "restricted securities"; and

(8) Securities acquired from the issuer in a transaction subject to an exemption under Section 4(6) of the 1933 Act.

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issuer that is a reporting company under the 1934 Act) or one year after the date such securities are purchased from the issuer or an affiliate of the issuer (in the case of an issuer that is not a reporting company under the 1934 Act). An affiliate (*i.e.*, control person) or any other person who sells restricted securities for his own account pursuant to Rule 144 is deemed not to be engaged in a distribution and therefore is not engaged in a transaction involving an underwriter. Additionally, persons selling both restricted or unrestricted securities for the account of an affiliate under Rule 144 are not considered underwriters. In short, Rule 144 provides an exemption for (i) resales of an issuer's securities (whether acquired in a private placement or in the open market) by an affiliate of the issuer and (ii) resales of an issuer's privately placed securities by a person who is not an affiliate of the issuer.

When selling restricted securities, Rule 144 requires that current public information about the issuer be made available to purchasers. The amount and type of information that must be provided depends upon whether the issuer is a reporting company. The manner-of-sale and volume conditions of the rule no longer apply to sales by unaffiliated persons. An issuer that does not file required interactive data (or post such data on its web site) will not be deemed to have available adequate current public information for purposes of the resale exemption safe harbor provided by Rule 144.[361]

Additionally, restricted equity securities must be resold in broker's transactions where the broker does no more than execute the order (*i.e.*, the broker is not permitted to solicit or arrange for the solicitation of customers' orders to buy securities) or in transactions with a market maker. Restricted debt securities are not subject to any "manner of sale" requirements.[362] Finally, Rule 144 imposes various filing requirements and, for sales for the account of an affiliate of an issuer, limits the amount of securities that can be sold in a three-month period.

A holder of restricted securities of a reporting company under the 1934 Act that, at the time of sale, is not an affiliate of the issuer and has not been an affiliate of the issuer in the preceding three months, may resell such restricted securities after six months have elapsed since the later of the date the securities were acquired from the issuer or an affiliate of the issuer, subject only to the current public information requirements of Rule 144. After a twelve-month holding period, unlimited resales by such persons are permitted, whether or not the issuer is a reporting company under the 1934 Act.

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[361] See the discussion under the heading "Extensible Business Reporting Language ('XBRL')" in Chapter 7 (*Ongoing Reporting and Other Requirements*).

[362] Rule 144(a)(4) under the 1933 Act defines "debt securities" as any security other than an equity security, except that non-convertible preferred securities with generally customary terms would also be within the definition; however, preferred securities are only eligible to be treated as debt if their terms include a liquidation preference in excess of par, which may constitute a trap for the unwary. Asset-backed securities are also considered debt securities.

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The following chart, which appears in SEC Release No. 33-8869, summarizes the requirements for resale of restricted securities under Rule 144:

	Affiliate or Person Selling on Behalf of an Affiliate	**Non-Affiliate (and Has Not Been an Affiliate During the Prior Three Months)**
Restricted Securities of Reporting Issuers	During six-month holding period - no resales under Rule 144 permitted. After six-month holding period - may resell in accordance with all Rule 144 requirements including: • Current public information, • Volume limitations, • Manner of sale requirements for equity securities, and • Filing of Form 144.	During six-month holding period - no resales under Rule 144 permitted. After six-month holding period but before one year - unlimited public resales under Rule 144 except that the current public information requirement still applies. After one-year holding period - unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.
Restricted Securities of Non-Reporting Issuers	During one-year holding period - no resales under Rule 144 permitted. After one-year holding period - may resell in accordance with all Rule 144 requirements, including: • Current public information, • Volume limitations, • Manner of sale requirements for equity securities, and • Filing of Form 144.	During one-year holding period - no resales under Rule 144 permitted. After one-year holding period - unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.

"Section 4(1½)"

Although not formally adopted as a safe harbor by the SEC, the terms of some privately-placed securities permit investors (in accordance with specified procedures) to resell those securities to other institutional accredited investors that would have been eligible

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to purchase the securities in the original private placement. This is the so-called "Section 4(1½)" exemption, which was largely developed by the securities bar and has been acknowledged by the SEC only in no-action letters. Resales pursuant to the Section 4(1½) exemption are generally considered exempt from the registration requirements of the 1933 Act. Historically, Section 4(1½) was the primary exemption used for the resale of privately placed securities. Following the adoption of Rule 144A, which permits resales of privately placed securities to QIBs, the Section 4(1½) exemption has been used primarily for resales of privately placed securities that may not qualify for Rule 144A.

Rule 144A Resales

As discussed in more detail above, Rule 144A under the 1933 Act permits resales of privately-placed securities to QIBs. (It is important to remember that Rule 144A does not apply to the original issuance and sale of securities by the issuer, and is therefore available only for resales of privately placed securities by third parties.) However, unlike Rule 144, privately placed securities resold pursuant to Rule 144A remain restricted securities and therefore may only be transferred pursuant to a registration statement filed under the 1933 Act or an exemption from 1933 Act registration. As discussed in more detail above,[363] Rule 144A is not available for securities that are of the same class as securities of the issuer that are listed on a U.S. securities exchange or automatic quotation system, and Rule 144A is not be available for certain exchangeable or convertible securities. In order to allow its investors to take advantage of Rule 144A, a U.S. issuer that does not file periodic reports with the SEC under the 1934 Act must agree to provide, on request to secondary market purchasers at or prior to the time of sale, (1) a very brief statement of the nature of the business of the issuer and the products and services it offers and (2) its most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation (the financial statements should be audited to the extent reasonably available).

Offshore Resales

In addition to applying to primary offerings, Regulation S provides a safe harbor for resales of restricted securities. The resale safe harbor applies to persons other than the issuer, any distributor, any of their affiliates (except an officer or director who is an affiliate solely by virtue of such position) or any person acting on their behalf. Similar to the Regulation S safe harbor for issuer and distributor transactions, the resale safe harbor requires that the offer and sale be made in an offshore transaction and prohibits any directed selling efforts in the United States. The offshore transaction requirement means that the buyer must be outside the United States or that the seller and any person acting on the seller's behalf must reasonably believe this to be the case. In the alternative, the transaction must be executed on or through a "designated offshore securities market" without any knowledge on the part of

[363] See "Private Placements – Rule 144A Offerings" above.

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the seller or any person acting on the seller's behalf that the transaction has been pre-arranged with a buyer in the United States.

Additional conditions apply to resales by certain affiliates or securities professionals. Those who are affiliates of an issuer or a distributor solely because they hold officer or director positions may rely on the resale safe harbor if they pay no more than the usual and customary broker's commission received by those who execute such transactions as agent. Dealers or others receiving selling compensation in connection with a Regulation S offering may rely on the safe harbor to resell securities prior to the expiration of the applicable distribution compliance period if (1) neither the seller nor any person acting on its behalf knows the offeree or buyer to be a U.S. person and (2) a confirmation or other notice of applicable restrictions is sent to any purchaser known to be another securities professional.

Equity securities of domestic issuers acquired in a Regulation S transaction are deemed restricted securities under Rule 144. As such, these securities may only be resold if the offshore purchaser does so in accordance with Regulation S, the registration requirements of the 1933 Act or an exemption therefrom.

EXEMPT SECURITIES UNDER THE 1933 ACT

Exempt securities under the 1933 Act include commercial paper, securities issued or guaranteed by a U.S. bank or a regulated U.S. branch or agency of a non-U.S. bank, securities exchanged for securities held by existing securityholders and other specified securities.

Commercial Paper

Section 3(a)(3) of the 1933 Act exempts short-term securities with maturities of nine months or less where the proceeds are to be used for current transactions. This is referred to as the "commercial paper" exemption. In determining whether the proceeds of an offering are to be used for current transactions, there is no requirement to trace the proceeds of the offering. It is sufficient that the issuer has qualifying current assets and operating expenses incurred during the past year in an amount equal to or exceeding the amount of the issuer's outstanding commercial paper. The SEC and the courts have said that this exemption is only available for prime-quality securities (*e.g.*, securities rated investment grade by at least one NRSRO) that are of a type not ordinarily sold to the general public.

Commercial paper that cannot satisfy the requirements of the commercial paper exemption under the 1933 Act may nevertheless be exempt from registration if it is offered pursuant to the private placement exemption afforded by Section 4(a)(2) or if the commercial paper is supported by a letter of credit issued by a U.S. bank or a federal or state branch or agency of a non-U.S. bank.

See *Accessing the U.S. Capital Markets – Securities Products* for a further discussion of commercial paper.

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Securities Issued or Guaranteed by a Bank or a Regulated U.S. Branch or Agency of a Non-U.S. Bank

Section 3(a)(2) of the 1933 Act exempts any security issued or guaranteed by a bank. The SEC has interpreted Section 3(a)(2) also to exempt debt securities (including deposits) issued or guaranteed by a U.S. branch or agency of a non-U.S. bank provided that the nature and extent of state or federal supervision of the U.S. branch is substantially equivalent to that applicable to state or federally-chartered U.S. banks doing business in the same jurisdiction.[364] On the basis of the foregoing, debt securities issued or guaranteed by U.S. branches and agencies of non-U.S. banks qualify as exempt securities pursuant to Section 3(a)(2). It is not necessary that the branch or agency of the non-U.S. bank be a separate subsidiary incorporated in the United States. Securities issued or guaranteed by a bank holding company are not exempt under Section 3(a)(2).

Letters of credit constitute guarantees for purposes of the Section 3(a)(2) exemption. Accordingly, bank letters of credit that support the securities of non-banks have been used in the U.S. capital markets not only as credit enhancement, but also as a way to avoid registration of the non-bank securities under the 1933 Act.

See Chapter 13 (*Bank Issuers*) for a further discussion of bank issuers.

Exchanged Securities

Section 3(a)(9) of the 1933 Act exempts securities exchanged by an issuer exclusively with its existing securityholders where no commission or other remuneration is paid for soliciting the exchange. This exemption is frequently relied upon in connection with recapitalizations where an issuer offers to exchange new securities for existing securities. It is also relied upon for the issuance of securities upon the conversion of the issuer's convertible securities.[365]

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[364] See SEC Release No. 33-6661 (Sept. 23, 1986) (hyperlink unavailable).

[365] On the basis of Section 3(a)(9) of the 1933 Act, the SEC has taken a "no-action" position in certain situations where a security of an issuer with a downstream guarantee from its parent was exchangeable for a newly issued security of such parent. Significant SEC No-Action Letters include: The Warnaco Group, Inc., available August 7, 1998, and Echo Bay Mines, Ltd., available May 18, 1998 (securities issued by a finance subsidiary and guaranteed by its parent that are exchangeable for a parent security); Kerr McGee Corporation, available July 31, 2001, Nabors Industries, Inc., available April 29, 2002, Weatherford International, Inc., available June 25, 2002, and Duke Energy Corporation, available March 30, 2006 (an issuer reorganizes to create a holding company and the new parent guarantees the outstanding securities of the issuer, which are thereafter exchangeable for a parent security); and Grand Metropolitan Public Limited Company, available April 14, 1998, Time Warner, Inc., available November 15, 2000, and B.P. Amoco p.l.c., available March 27, 2001 (an acquiror guarantees the outstanding securities of the acquired company, which are thereafter exchangeable for securities of the acquiror). More recently, the SEC also has taken a "no-action" position on the basis of Section 3(a)(9) of the 1933 Act in certain situations where a security of an issuer with one or more upstream guarantees from its 100%-owned subsidiaries was exchangeable for a

(continued)

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Other Exempt Securities

Other exempt securities include:

- U.S. government obligations (securities issued or guaranteed by the United States or any person "controlled or supervised by and acting as an instrumentality" of the U.S. government pursuant to statutory authority);

- municipal obligations (securities issued or guaranteed by the States of the United States and territories, their political subdivisions and public instrumentalities, or the District of Columbia);

- railroad equipment trust certificates;

- insurance contracts;[366] and

- securities issued by charitable organizations, intrastate offerings and certain small issues (Regulation A offerings and those made in compliance with Rule 504 of Regulation D).

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newly issued security of such parent. See SEC No-Action Letter Davis Polk & Wardwell LLP, available January 13, 2010.

366 Applies only to insurance contracts and policies, not securities issued by insurance companies. See Chapter 14 (*Insurance Company Issuers*).

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CHAPTER 9

1940 ACT-EXEMPT ISSUERS

GENERAL 282
NON-PRIMA FACIE INVESTMENT COMPANIES 283
RULE 3a-1 ISSUER 284
TRANSIENT INVESTMENT COMPANIES 284
COMMERCIAL PAPER FINANCE SUBSIDIARIES 285
FINANCE SUBSIDIARIES 285
NON-U.S. BANKS, INSURANCE COMPANIES AND SIMILAR INSTITUTIONS 286
STRUCTURED FINANCING VEHICLES 286
CERTAIN RESEARCH AND DEVELOPMENT COMPANIES 289
PRIVATE INVESTMENT FUNDS 290
ENTITIES PRIMARILY ENGAGED IN HOLDING RECEIVABLES, REAL ESTATE OR MORTGAGES 293
ENTITIES ENGAGED IN THE OWNERSHIP OF OIL OR GAS ASSETS 294

GENERAL

Any issuer holding significant amounts of securities (which are broadly defined under the 1940 Act to include loans, minority interests in affiliated companies and other assets not normally thought of as securities) may be viewed as an investment company. An issuer is a prima facie investment company subject to regulation under the 1940 Act if it is engaged in the business of investing, reinvesting, owning, holding or trading in securities and owns or proposes to acquire investment securities having a value exceeding 40% of the value of its total assets (exclusive of Government securities and cash items) on an unconsolidated basis. As discussed below, an exemption from registration under the 1940 Act is often available to an issuer.

The 1940 Act exemptions that are relied upon by issuers that might otherwise be viewed as an investment company under the 1940 Act include exemptions for:

- Rule 3a-1 issuers;
- transient investment companies;
- commercial paper finance subsidiaries;
- finance subsidiaries;
- non-U.S. banks, insurance companies and similar institutions;
- structured finance vehicles;

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- certain research and development companies;
- private investment funds; and
- entities primarily engaged in holding receivables, real estate or mortgages.

It should be noted that, if an issuer would fall under the definition of an investment company under the 1940 Act, the problem generally cannot be solved by issuing securities through a special-purpose finance subsidiary. For the most part, exemptions for finance subsidiaries under the 1940 Act do not apply when the parent of the issuer is an investment company within the meaning of the 1940 Act.

NON-PRIMA FACIE INVESTMENT COMPANIES

An issuer can avoid application of the 1940 Act if it is not a prima facie investment company or if it can take advantage of the exemption afforded by Rule 3a-1 under the 1940 Act or another exemption or exception provided under the 1940 Act. In either case, the issuer cannot be engaged or hold itself out as being engaged primarily in the business of investing, reinvesting or trading in securities.[367]

Whether less than 40% of the value of an issuer's assets constitute investment securities is determined by dividing the value of the issuer's investment securities by the aggregate value of those investment securities and the other assets (other than Government securities and cash items)[368] owned, on an unconsolidated basis, by the issuer.

It is important to emphasize that, for purposes of the above computation, the analysis is done on an unconsolidated basis. Thus, it becomes necessary to analyze each subsidiary of the issuer separately to determine whether or not that subsidiary is itself an investment company (or an issuer relying on Sections 3(c)(1) or 3(c)(7) of the 1940 Act) in order to determine whether or not the issuer's holdings in that subsidiary should be considered investment securities.

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[367] The Rule 3a-1 exemption is only available to those issuers falling under the 1940 Act's definition of "investment company" in Section 3(a)(1)(C), but not to those covered by Sections 3(a)(1)(A) and (B). In addition, Rule 3a-1 is not available to an issuer that is a special situation investment company (generally considered to be a company which secures control of other companies primarily for the purpose of making a profit in the sale of the controlled company's securities). See Certain Prima Facie Investment Companies, SEC Release No. IC-10937 (Nov. 1979). See Rule 3a-1(b).

[368] For example, cash on hand, demand (not time) deposits, checks payable in immediately available funds, cashier checks, bank drafts and letters of credit. Certificates of deposit generally would not be considered cash items. In SEC No-Action Letter, Willkie Farr & Gallagher, available Oct. 23, 2000, the SEC agreed that (subject to the terms and conditions set forth in the letter) an issuer may treat as cash items for purposes of Section 3(a)(1)(C) of the 1940 Act, and Rule 3a-1 thereunder, shares of a registered investment company that holds itself out as a money market fund and seeks to maintain a stable net asset value of $1.00 per share.

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An alternative way to perform the above computation, which is often easier because it helps to avoid uncertainties that exist in the definition of "securities," is to focus on assets that clearly are not securities (*e.g.*, inventory, property, plant and equipment) and determine whether these assets exceed 60% of total assets.

RULE 3a-1 ISSUER

Even if an issuer constitutes a prima facie investment company under the 1940 Act, it will not be deemed an investment company under the 1940 Act if, pursuant to Rule 3a-1, (i) no more than 45% of the value of the issuer's total assets (exclusive of government securities and cash items), consolidated only with the assets of any "wholly-owned subsidiary" (defined, for purposes of the 1940 Act and the rules thereunder, as a company 95% or more of the voting securities of which are owned by a natural person or company, or by a company which is itself a wholly-owned subsidiary (within the meaning of the defined term)) consists of securities other than "Good Assets" and (ii) no more than 45% of the issuer's net income after taxes, again consolidated only with the net income of any wholly-owned subsidiary (for the last four fiscal quarters combined) is derived from securities other than "Good Assets."[369] "Good Assets" include government securities, securities issued by employees' securities companies, securities issued by majority-owned subsidiaries, excluding subsidiaries relying on the exclusion of Section 3(b)(3) or Sections 3(c)(1) or 3(c)(7) of the 1940 Act,[370] securities of companies controlled primarily by the issuer through which the issuer engages in a business other than that of investing, reinvesting, owning, holding or trading in securities, and that are not themselves investment companies, and various assets other than securities.

In addition, to satisfy Rule 3a-1, the issuer must not be an investment company as defined in Section 3(a)(1)(A) or 3(a)(1)(B) of the 1940 Act (*i.e.,* it must not (i) be or be holding itself out as being engaged primarily, or proposing to engage primarily, in the business of investing, reinvesting or trading in securities, and (ii) be engaged or proposing to engage in the business of issuing face-amount certificates of the installment type (or have been engaged in such business and have any such certificates outstanding)), and it may not be a special situation investment company.

TRANSIENT INVESTMENT COMPANIES

Rule 3a-2 under the 1940 Act permits an issuer to be deemed not to be engaged in the business of investing, reinvesting, owning, holding or trading in securities during a period not exceeding one year provided that the issuer has a *bona fide* intent to be engaged primarily as

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369 The issuer's holdings of securities of less than wholly-owned subsidiaries, and its net income derived therefrom, are examined on an unconsolidated basis.

370 Although Rule 3a-1 under the 1940 Act has not been revised specifically to exclude securities issued by Section 3(c)(7) companies from being treated as "Good Assets," there is a significant risk that the SEC will interpret the rule in that fashion.

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soon as reasonably possible in a business other than the foregoing and meets the other conditions of the Rule (including an appropriate resolution of the issuer's board of directors). This exemption may be relied upon only once in any three-year period.

COMMERCIAL PAPER FINANCE SUBSIDIARIES

Generally speaking, Rule 3a-3 under the 1940 Act exempts from the registration provisions thereof any wholly-owned finance subsidiary that only issues short-term paper with a maturity of no more than nine months and whose parent satisfies the conditions of Rule 3a-1(a) and which (i) is not an investment company as defined in Section 3(a) of the 1940 Act, (ii) is excluded from the definition of the term "investment company" by Section 3(b)(1) or Section 3(b)(2) of the 1940 Act, or (iii) is deemed not to be an investment company for purposes of the 1940 Act by Rule 3a-1 under the 1940 Act. Subsidiaries of certain types of parents (*e.g.*, those described below as primarily engaged in holding receivables) may not rely on Rule 3a-3 since the parent would not satisfy Rule 3a-1(a) in the first instance but rather relies on Section 3(c) of the 1940 Act as its exception.[371]

FINANCE SUBSIDIARIES

Rule 3a-5 under the 1940 Act is intended to exempt from the definition of investment company any issuer that is organized primarily to finance the business operations of its parent company and any subsidiaries of the parent company. Rule 3a-5 applies to any finance subsidiary whose securities, other than debt securities or non-voting preferred stock or directors' qualifying shares, are wholly-owned by the parent or companies controlled by the parent if the debt securities and non-voting preferred stock it sells to the public in the United States are unconditionally guaranteed by its parent and at least 85% of the funds raised are advanced to its parent or a company controlled by its parent within six months of receipt by the finance subsidiary. In the case of non-voting preferred stock issued by the finance subsidiary, the guarantee need only extend to dividends which have been declared by the subsidiary's board of directors and, upon liquidation, the lower of the liquidation preference plus accumulated and unpaid dividends, or the subsidiary's remaining assets after satisfaction of prior claims.[372] It is uncertain whether the parent company must guarantee the cash equivalent value of the subsidiary's assets, or whether it is enough for the parent company only to guarantee that the subsidiary's assets be distributed. Although the SEC has granted a no-action letter where the company argued in favor of the latter, the SEC has not explicitly stated its position on this issue.[373] The parent company, and any company controlled by the parent company that owns stock of or borrows from the finance subsidiary, must not be an investment company under Section 3(a) of the 1940 Act, or must be excepted

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[371] For additional information, see Chapter 10 (*Finance Subsidiaries*).

[372] See SEC No-Action Letter Chieftain International Funding Corp., available Nov. 3, 1992.

[373] See SEC No-Action Letter KDSM, Inc., Sinclair Capital, available Mar. 17, 1997.

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or exempted from the definition of investment company by Section 3(b) or by the rules or regulations under Section 3(a) of the 1940 Act.

As presently interpreted by the SEC, a support agreement does not satisfy the guarantee requirements of Rule 3a-5. However, the staff of the SEC has acknowledged that a guarantee is not required in connection with securities that are privately placed[374] or sold pursuant to Regulation S,[375] even if the securities are eligible for resale pursuant to Rule 144A.[376] Moreover, an irrevocable letter of credit meeting certain prescribed conditions and issued by a parent that is a "foreign bank" under Rule 3a-6 under the 1940 Act may be used in lieu of a guarantee.

Rule 3a-5 also limits the types of short-term investments that a finance subsidiary may make. The SEC has granted no action relief to finance subsidiaries investing in instruments not specifically listed in the rule when such instruments are consistent with the rule's purpose.[377] No-action relief has also been granted with respect to business trusts under the rule.[378]

NON-U.S. BANKS, INSURANCE COMPANIES AND SIMILAR INSTITUTIONS

Rule 3a-6 under the 1940 Act provides that non-U.S. banks, insurance companies and certain other specified institutions that issue securities in the United States and meet the definitional and other requirements of the rule do not have to register under the 1940 Act. Among other applicable requirements, a foreign bank must be "engaged substantially in commercial banking activity."[379] U.S. branches of non-U.S. banks, however, may be exempt under Section 3(c)(3) of the 1940 Act, the same statutory exception available to U.S. banks (and U.S. insurance companies). Because Rule 3a-6 exempts their subsidiaries, non-U.S. banks or insurance holding companies generally need not register under the 1940 Act.

STRUCTURED FINANCING VEHICLES

Rule 3a-7 under the 1940 Act exempts from the definition of investment company any structured financing vehicle that complies with the terms of the rule. In the release

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[374] See SEC No-Action Letter PSEG Capital Corp., available July 13, 1988; see also SEC No-Action Letter Econo Lodges of America, Inc., available Dec. 22, 1989.

[375] See SEC No-Action Letter Societe Generale and SGA Societe Generale Acceptance, available Feb. 14, 1992.

[376] See SEC No-Action Letter Sony Capital Corporation, available Apr. 27, 1992.

[377] See SEC No-Action Letter Hewlett Packard Finance Company, available July 17, 1996.

[378] See Chapter 10 (*Finance Subsidiaries*).

[379] For discussion of what might be deemed to constitute such activity, see SEC No-Action Letter Seward & Kissel, available Oct. 12, 2005.

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adopting Rule 3a-7,[380] the SEC indicated that the terms of Rule 3a-7 are intended to reflect the structural and operational distinctions between registered investment companies and structured financing vehicles and incorporate investor protections currently imposed by the market. Rule 3a-7 also is intended to accommodate future innovations in the structured finance market, consistent with investor protection. However, the SEC staff is currently construing the terms of Rule 3a-7 very narrowly, making it especially important to identify potential interpretative issues.

Rule 3a-7 exempts qualifying structured financing vehicles that invest in virtually any type of security (other than common or preferred stock), including most types of notes, bonds, debentures, evidences of indebtedness, certificates of deposit, leases, installment contracts, interest rate swaps, repurchase agreements, guaranteed investment contracts, accounts receivable, chattel paper, guarantees, annuities, credit card receivables, revolving home equity loans, dealer warehouse receivables and mortgage pass-through certificates. Rule 3a-7 also permits the holding of various assets for the purpose of credit enhancement, as well as ancillary or incidental assets.

In order to qualify for Rule 3a-7, an issuer must be engaged in the business of purchasing, or otherwise acquiring, and holding eligible assets[381] (and in activities related or incidental thereto), and may not issue securities redeemable at the option of the holder. A redeemable security has been broadly defined by the SEC staff to include many types of securities containing put provisions.[382]

The following conditions also apply:[383]

(1) The issuer must issue fixed-income securities or other securities which entitle their holders to receive payments that depend primarily on the cash flow from eligible assets. Thus, securities that depend upon market value fluctuations of underlying assets do not qualify.

(2) Securities sold by the issuer or any underwriter must be fixed-income securities rated, at the time of initial sale, in one of the four highest categories

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[380] See SEC Release No. IC-19105 (Nov. 19, 1992) (hyperlink unavailable).

[381] The term "eligible assets" is defined in Rule 3a-7 as "financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure servicing or timely distribution of proceeds to security holders." Compare to the definition of "asset-backed security" in Regulation AB referenced in the instructions to Form S-3.

[382] See SEC No-Action Letter Nebraska Higher Education Loan Program, Inc., available Apr. 3, 1998.

[383] Section 939A of the Dodd-Frank Act requires the SEC to review references to credit ratings in SEC regulations, remove the references and substitute an appropriate alternative standard of credit-worthiness. In August 2011, the SEC issued a notice of proposed rulemaking relating to Rule 3a-7 setting forth possible new conditions. See Treatment of Asset-Backed Issuers under the Investment Company Act, SEC Release No. IC-29779 (Aug. 31, 2011).

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assigned to long-term debt or in an equivalent short-term debt category by at least one NRSRO that is not an affiliated person of the issuer or of any person involved in the organization or operation of the issuer, except that:

- any fixed-income securities, rated or not, may be sold to institutional accredited investors (*i.e.*, accredited investors as defined in paragraphs (1), (2), (3), and (7) of Rule 501(a) under the 1933 Act); and

- any securities may be sold to QIBs and to persons (other than any rating agency rating the issuer's securities) involved in the organization or operation of the issuer or an affiliate of such person,

provided that the issuer or any underwriter effecting such sale exercises reasonable care to ensure that such securities are sold and will be resold to institutional accredited investors or QIBs, as the case may be.

(3) The issuer may acquire additional eligible assets, or dispose of eligible assets, only if:

- the assets are acquired or disposed of in accordance with the terms and conditions set forth in the agreements, indentures, or other instruments pursuant to which the issuer's securities are issued;

- the acquisition or disposition of the assets does not result in a downgrading of the rating of the issuer's outstanding fixed-income securities; and

- the assets are not acquired or disposed of for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.

(4) If the issuer issues any securities other than Section 3(a)(3) commercial paper, the issuer must appoint an independent trustee which, among other things, meets certain requirements of the 1940 Act. The trustee must be a U.S. bank or a U.S. branch or agency of a non-U.S. bank.[384] The issuer must take reasonable steps to cause the trustee to have a perfected security interest or ownership interest valid against third parties in the eligible assets that principally generate the cash flow needed to pay the fixed-income

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[384] The 1940 Act's definition of "bank" includes not only those organized pursuant to the laws of the United States, but also "branch[es] or agenc[ies] of a foreign bank (as such terms are defined in Section 1(b) of the International Banking Act of 1978)" as well. As such, a branch or agency of a non-U.S. bank (as defined above) may also be an acceptable trustee for purposes of Rule 3a-7 under the 1940 Act.

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securityholders. The cash flows must be deposited periodically in a segregated account maintained or controlled by the trustee.

CERTAIN RESEARCH AND DEVELOPMENT COMPANIES

Rule 3a-8 under the 1940 Act provides a nonexclusive safe harbor from the definition of investment company for certain *bona fide* research and development companies. An issuer will be eligible to use Rule 3a-8 if:

(1) its research and development expenses, for the last four fiscal quarters combined, are a substantial percentage of its total expenses for the same period;[385]

(2) its net income derived from investments in securities, for the last four fiscal quarters combined, does not exceed twice the amount of its research and development expenses for the same period;

(3) its expenses for investment advisory and management activities, investment research and custody, for the last four fiscal quarters combined, do not exceed 5% of its total expenses for the same period;

(4) its investments in securities, with certain exceptions, are capital preservation investments;

(5) it does not hold itself out as being engaged in the business of investing, reinvesting or trading in securities, and it is not a special situation investment company;

(6) it is primarily engaged, directly, through majority-owned subsidiaries, or through companies which it controls primarily, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities; and

(7) its board of directors has adopted a written investment policy with respect to the issuer's capital preservation investments.

The SEC has provided guidance on proposed investments that may constitute "capital preservations investments" for purposes of Rule 3a-8(b)(4).[386]

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[385] The SEC has provided guidance on what constitutes a "substantial percentage" for this purpose. See SEC No-Action Letter Cooley Godward Kronish LLP, available July 12, 2007.

[386] See SEC No-Action Letter Ark Therapeutics Group plc, available Apr. 15, 2005.

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PRIVATE INVESTMENT FUNDS[387]

Section 3(c)(1) Exemption

Section 3(c)(1) of the 1940 Act affords an exemption from 1940 Act registration that is commonly used in connection with certain structured financings and in financings where the issuer is an operating company whose assets (*e.g.*, leases or promissory notes) cause the issuer to be considered an investment company. Section 3(c)(1) excludes from the definition of investment company:

> [a]ny issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.

In order for an issuer to comply with Section 3(c)(1) as interpreted by the SEC, all of its securities must be privately offered pursuant to Section 4(a)(2) or Regulation D under the 1933 Act[388] and the number of beneficial owners of its securities (other than holders of its short term paper) must be 100 or less.[389] The 100-owner limit is an ongoing restriction, which necessitates certain transfer restrictions and related procedures. When counting the number of securityholders, attribution rules apply to certain investors holding 10% or more of an issuer's voting securities.[390] The SEC has adopted Rule 3c-5 under the 1940 Act which

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[387] Note that private funds generally rely on Rule 506 under the 1933 Act to make private offerings, which, with some exceptions, requires that the investors be "accredited investors" as defined in Section 501. Also, investors in private funds that impose performance fees must be "qualified clients" as defined in Rule 205-3 under the Investment Advisers Act of 1940.

[388] The Jumpstart Our Business Startups Act (the "JOBS Act"), which was signed into law in April 2012, requires the SEC to amend Regulation D to permit general solicitation and general advertising provided that sales are made only to accredited investors. While the SEC has proposed amendments to Regulation D and Rule 144A, it has not taken any final action. The relief to be provided will not apply to Section 4(a)(2) offerings made outside of Rule 506 or to private placements by persons other than the issuer. Although the JOBS Act does not expressly amend the 1940 Act, it does provide that offers and sales under revised Rule 506 "shall not be deemed public offerings under Federal securities laws as a result of general advertising or general solicitation."

[389] It should be noted that, as interpreted by the SEC, the 100-owner limit is imposed differently depending upon the residency of the issuer. If the issuer is a U.S. issuer, the 100-owner limit applies to all holders. If, on the other hand, the issuer is a non-U.S. issuer, the 100-owner limit applies to U.S. residents. See, *e.g.*, SEC No-Action Letter Touche Remnant & Co., available Aug. 27, 1984. Furthermore, in the case of a non-U.S. issuer, the SEC has indicated that the 100-owner limit need not apply to those U.S. residents who purchased their securities while residing outside the United States and have subsequently relocated to the United States or to those U.S. residents who make offshore secondary market purchases without the involvement of the non-U.S. issuer, its affiliates, agents or intermediaries. See SEC No-Action Letter Investment Funds Institute of Canada, available Mar. 4, 1996.

[390] Beneficial ownership by a company is considered beneficial ownership by one person unless the company (1) owns 10% or more the issuer's outstanding voting securities and (2) is an investment company or would be considered an investment company but for the exceptions provided in Section 3(c)(1) or 3(c)(7). If the (continued)

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generally permits "knowledgeable employees" of a Section 3(c)(1) issuer, subject to the requirements of the rule, to acquire securities issued by the issuer without being counted as beneficial owners for purposes of the 100-owner limit. There are various SEC interpretations regarding ownership by certain entities such as retirement plans, trusts and partnerships.[391]

Despite compliance with the express provisions of Section 3(c)(1), the SEC may look through entities that exist only to circumvent the 1940 Act. Such determinations are ultimately based on an analysis of all of the surrounding facts and circumstances.[392] However, when an issuer represents that it will not invest more than 40% of its committed capital in the Section 3(c)(1) company, the SEC has generally granted no-action relief.

Qualified Purchaser Exemption

Section 3(c)(7) of the 1940 Act exempts from the provisions of the 1940 Act any issuer whose securities are (1) privately offered[393] and (2) beneficially owned exclusively by one or more persons who were "qualified purchasers" at the time of the acquisition.[394] Section 2(a)(51) of the 1940 Act defines "qualified purchaser" to include (1) individuals and certain family companies that have no less than $5 million in "investments" (as defined by the SEC),[395] (2) certain trusts if both the trustee or other person with investment discretion and all settlers or other contributors are "qualified purchasers," and (3) other persons that own and invest on a discretionary basis no less than $25 million in "investments." Rule 3c-5, described above, permits knowledgeable employees of a Section 3(c)(7) issuer to acquire securities without being qualified purchasers.

The qualified purchaser exemption is an ongoing test that applies to resales as well as initial sales of securities. Thus, for an issuer to avail itself of this exemption, every purchaser and subsequent transferee must satisfy the qualified purchaser definition as provided in Section 2(a)(51) and the rules thereunder. The SEC has simplified this problem somewhat in certain cases by adopting a rule under Section 2(a)(51) that provides that QIBs are generally treated as qualified purchasers for purposes of Section 3(c)(7), so long as they are acting for their own account or the account of another QIB that is a qualified purchaser.[396] In addition,

company satisfies these two conditions, the beneficial ownership is considered that of the holders of the company's outstanding securities (other than short-term paper).

[391] For SEC discussion of these and related issues, see SEC No-Action Letter American Bar Association Section of Business Law, available Apr. 22, 1999 (the "ABA Letter").

[392] See SEC No-Action Letter Cornish & Carey Commercial, Inc., available June 21, 1996.

[393] See *supra* notes 381 and 382.

[394] Section 3(c)(7) was added to the 1940 Act by the NSMIA.

[395] See Rule 2a51-1 under the 1940 Act.

[396] Rule 2a51-1(g) under the 1940 Act enumerates two specific exceptions to the treatment of QIBs as qualified purchasers. The first exception relates to dealers. To be considered a qualified purchaser, a dealer must own and invest in a discretionary basis $25 million of securities of unaffiliated issuers.
(continued)

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the SEC has adopted a reasonable belief standard to determine whether a prospective qualified purchaser is actually a qualified purchaser. Issuers that reasonably believe a purchaser of securities is a qualified purchaser are covered by the qualified purchaser exemption.

Section 12(g) of the 1934 Act, as amended by the JOBS Act, requires issuers of securities to register with the SEC and thereby become public reporting companies within 120 days of the end of any fiscal year in which they first have total assets exceeding $10 million and any class of equity securities held of record by 2,000 or more persons, or 500 persons who are not accredited investors, for most issuers. However, although the 1934 Act effectively allows an issuer to have up to 499 non-accredited holders of a class of equity securities without becoming a public reporting company, it should be noted that the thirty-five-person limit under Rule 506 of Regulation D on investors that are not accredited investors has not been increased.

Foreign private issuers intending to rely on Section 3(c)(7) should consult U.S. counsel with respect to procedures to be considered if they wish to use the book-entry facilities of DTC.[397]

Section 619 of the Dodd-Frank Act sets forth the "Volcker Rule," which restricts, among other things, the ability of banking entities (as defined) to acquire or retain any interest in a hedge fund (including a 3(c)(1) or 3(c)(7) fund) or private equity fund, or sponsor any hedge fund or private equity fund. A conformance rule provides entities covered by the Volcker Rule with a period of two years after the date that the Volcker Rule took effect, which would be until July 21, 2014, to fully conform their activities and investments to the requirements of the Volcker Rule, unless that period is extended by the Federal Reserve Board on a case by case base. Up to three (3) one-year extensions are available, plus one (1) five-year extension for divestiture of certain illiquid funds.

However, a dealer that does not meet this standard could still be a qualified purchaser if the dealer owns and invests on a discretionary basis $25 million of investments determined in accordance with Rule 2a51-1. The second exception relates to employee benefit plans and their related trusts. Self-directed employee benefit plans are generally not considered qualified purchasers for purposes of Rule 2a51-1. Issuers should look through the plan to its participants to determine whether each investor is a qualified purchaser. Two other more general exceptions are found in Rule 2a51-3 and Section 2(a)(51)(C) of the 1940 Act. Rule 2a51-3 states that a company will not be deemed a qualified purchaser if it was formed for the specific purpose of acquiring the securities offered by a company excluded from the definition of investment company by Section 3(c)(7) unless each of its beneficial owners is a qualified purchaser. Section 2(a)(51)(C) mandates that privately offered funds wishing to be considered qualified purchasers must obtain the unanimous consent of all beneficial owners that invested in the fund other than for short-term paper on or before April 30, 1996.

[397] See "New Developments in Procedures for Book-Entry Deposit of Rule 144A Securities by 3(c)(7) Issuers," The Investment Lawyer, Vol. 10, March-April 2003.

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ENTITIES PRIMARILY ENGAGED IN HOLDING RECEIVABLES, REAL ESTATE OR MORTGAGES

Section 3(c)(5) of the 1940 Act is commonly used by non-bank financial institutions such as traditional sales finance companies and mortgage banks. Section 3(c)(5) provides a statutory exception generally to issuers that do not issue securities redeemable at the option of the holder and are primarily engaged in one or more of the following businesses:

(1) purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance and services;

(2) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and

(3) purchasing[398] or otherwise acquiring mortgages and other liens on and interests in real estate.

Frequently, sales finance companies and leasing companies do not qualify for the Section 3(c)(5) exception because their credit operations are not targeted to specific merchandise. The SEC has taken the view that notes representing general loans for unspecified goods and services, even if secured by collateral typically associated with sales financing, do not qualify as receivables under Sections 3(c)(5)(A) and (B).[399] As such, generalized credit operations not tied to sales financings or holding receivables with respect to specific merchandise or services are not entitled to the Section 3(c)(5)(B) exception.[400]

In connection with establishing U.S. commercial paper and medium-term note programs, a number of U.S. leasing company subsidiaries of non-U.S. corporations, particularly non-U.S. leasing companies, have encountered additional difficulties when seeking to avoid registration under the 1940 Act. For example, it is presently unclear whether leases constitute securities for purposes of the 1940 Act. If they do, then the leasing companies would in the first instance constitute investment companies for purposes of the 1940 Act. If the leases constitute sales financings (*i.e.*, the leased property may be purchased by the lessee for nominal consideration at the end of the lease term), then the Section 3(c)(5)(A) exception may be available.

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[398] The SEC is currently reviewing interpretive issues relating to the status of mortgage-related pools under the 1940 Act. In August 2011, the SEC issued a concept release requesting information from the public about mortgage-related pools, and soliciting views about the application of Section 3(c)(5)(C) of the 1940 Act to mortgage-related pools. See Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments, SEC Release No. IC-29778 (Aug. 31, 2011).

[399] See, *e.g.*, SEC No-Action Letter New England Education Loan Marketing Corporation, available May 22, 1998.

[400] See, *e.g.*, SEC No-Action Letter Alleco, Inc., available July 14, 1988.

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Another issue that frequently arises is whether the securities proposed to be issued may be viewed by the SEC as redeemable, thus making the Section 3(c)(5) exception unavailable. The SEC considers debt securities to be redeemable when the holder is able to put the securities back to the issuer or its agent. Where the put is available only under very limited circumstances, however, it will not invalidate the exception. Put features should be examined on a case-by-case basis to determine whether the exception is available.

The Section 3(c)(5) exception under the 1940 Act is used not only by operating companies, but also for many types of structured financings involving mortgages and other financial assets. Regardless of the type of entity relying on the exemption, however, certain asset composition tests must be met. In the case of Sections 3(c)(5)(A) and 3(c)(5)(B), it is generally advisable that at least 65% of the issuer's assets be of the specified type. In the case of Section 3(c)(5)(C), regarding mortgage and real estate assets, there is generally a more complicated formula under which at least 55% of the assets must be so-called qualifying real estate assets such as whole mortgage liens and their functional equivalents, and at least 80% of the assets must consist of such mortgage and real estate assets or a combination of those assets and other assets related thereto.[401] Whole pool mortgage-backed securities have been viewed by the SEC as the equivalent of mortgage loans for purposes of this exception.[402]

ENTITIES ENGAGED IN THE OWNERSHIP OF OIL OR GAS ASSETS

Section 3(c)(9) of the 1940 Act provides an exception from the definition of "investment company" for "any person substantially all of whose business consists of owning or holding oil, gas or other mineral royalties or leases, or fractional interests therein, or certificates of interest or participation in or investment contracts relative to such royalties, leases or fractional interests." Generally, interests in oil and gas limited partnerships or joint ventures have been considered to be "certificates of interest or participation in or investment contracts relative to" oil or gas royalties or leases, and as a result, limited partnerships and joint ventures owning these interests have been able to rely on the exception provided by Rule 3(c)(9).[403] Separately, the SEC staff has found that interests in debt securities combined with conditional rights to receive overriding royalties are investment contracts; however, they are not "relative" to an oil or gas royalty within the meaning of Section 3(c)(9).[404] There is limited SEC or other precedent involving Section 3(c)(9).

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[401] See, *e.g.*, SEC No-Action Letters Citytrust, available Dec. 19, 1990; Greenwich Capital, available Aug. 8, 1991; see also SEC No-Action Letter NAB Asset Corp., available June 20, 1991.

[402] See, SEC No-Action Letter Capital Trust, Inc., available May 24, 2007 (in the circumstances outlined in the letter, a Tier 1 mezzanine loan was found to be a "qualifying interest"). See SEC Release No. 8456 (Aug. 9, 1974).

[403] See SEC Release No. 8456 (Aug. 9, 1974).

[404] See, SEC No-Action Letter Damson Oil Corporation, available Jan. 11, 1974.

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SECTION V. SELECTED ISSUERS

In most cases, the 1933 Act and the 1934 Act and the SEC, through its rules, regulations, interpretations and other actions, establish the disclosure and reporting requirements for issuers of securities in the U.S. capital markets. However, the 1933 Act and the 1934 Act sometimes distinguish among certain types of issuers. Accordingly, the SEC and other applicable U.S. securities industry regulators have adopted rules, regulations and interpretations that apply only to, specific types of issuers. Finance subsidiaries, REITs, banks and bank holding companies and insurance company issuers are among those and are discussed in this section.

The SEC has also adopted, under the 1933 Act and the 1934 Act, certain industry guides that require specialized disclosure with respect to specified industries. These guides, which can be found at http://www.sec.gov/about/forms/industryguides.pdf, need to be considered whenever preparing disclosure with respect to issuers to which they apply, cover the following matters:

- Disclosure of Oil and Gas Operations (Guide 2);[405]
- Statistical Disclosure by Bank Holding Companies (Guide 3);
- Interests in Oil and Gas Programs (Guide 4);
- Interests in Real Estate Limited Partnerships (Guide 5);
- Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters (Guide 6); and
- Description of Property by Issuers Engaged or to be Engaged in Significant Mining Operations (Guide 7).

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[405] See SEC Release No. 33-8995 (Dec. 31, 2008) (http://www.sec.gov/rules/final/2008/33-8995.pdf), which codified and revises the provisions currently set forth in Industry Guide 2 in Regulation S-K, and harmonized oil and gas disclosures by foreign private issuers with disclosures for U.S. issuers for fiscal years ending on or after January 1, 2010.

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CHAPTER 10

FINANCE SUBSIDIARIES

GENERAL 296
1933 ACT CONSIDERATIONS 296
1940 ACT CONSIDERATIONS 297
SUPPORT AGREEMENTS 302
RATING AGENCY REQUIREMENTS 302
1933 ACT AND 1934 ACT REGISTRATION AND REPORTING ISSUES 303

GENERAL

Many issuers access the U.S. capital markets through a special purpose U.S. finance subsidiary, which may issue commercial paper, medium-term notes, other debt securities and preferred securities. The proceeds from securities issued by these finance subsidiaries are advanced to the parent or to the parent's operating subsidiaries. Issuers also access the U.S. capital markets through sales finance company subsidiaries (*i.e.*, traditional finance companies).

An issuer may derive significant benefits by establishing a special purpose U.S. finance subsidiary. A special-purpose finance subsidiary provides an effective vehicle for credit–enhancing securities through asset over-collateralization or a letter of credit. With such credit enhancement, a finance subsidiary provides a way to issue highly-rated securities without requiring the parent to go through the rating process. In recent years, finance subsidiaries have enabled issuers to raise funds through the issuance of instruments that count as capital for regulatory, rating agency and other purposes.

Special-purpose finance subsidiaries organized in the United States to issue securities primarily in U.S. capital markets are generally organized under the laws of the State of Delaware. Delaware is customarily chosen because it does not impose burdensome restrictions on corporations, limited liability companies, statutory trusts and similar entities. Also, its entity level taxes are minimal and its corporation and trust laws have been extensively construed by the courts, thereby providing clear and modern precedent defining the rights and obligations of the entity and its directors, partners, trustees and/or securityholders. Organization in Delaware is a simple process. Corporate action may generally be taken by written consent. The board of directors may consist of a single person, and the directors need not be U.S. citizens or residents.

1933 ACT CONSIDERATIONS

To enhance the credit of a finance subsidiary, an issuer may need to issue a guarantee of the subsidiary's securities or enter into a support agreement with the finance subsidiary. If the credit enhancement is a guarantee, then the guarantee and the securities of the finance

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subsidiary constitute separate securities for purposes of the 1933 Act. Accordingly, for a registered public offering, both the issuer and the finance company would jointly file a 1933 Act registration statement. As discussed in Chapter 3 (*The Securities Registration and Reporting Process*), the finance subsidiary would be eligible to file on the same 1933 Act registration statement as the issuer, including the abbreviated Form S-3 (if applicable).

The information that a finance subsidiary must provide for guaranteed securities in registration statements under the 1933 Act and registration statements and reports under the 1934 Act will depend on the business of the finance subsidiary and the nature of the guarantee.[406] If the credit enhancement for a finance subsidiary is a guarantee and the subsidiary is only a wholly-owned funding conduit with no independent operations, the SEC's rules will not require the subsidiary to include separate financial statements in the 1933 Act registration or to comply, as a separate registrant, with the reporting requirements of the 1934 Act.[407]

If the credit enhancement for a finance subsidiary consists of a bank letter of credit, its securities should be exempt from registration under the 1933 Act by virtue of Section 3(a)(2).[408]

1940 ACT CONSIDERATIONS

In order to avoid the registration provisions of the 1940 Act, no more than 40% of a finance subsidiary's assets may be "investment securities" (as defined in the 1940 Act), or the finance subsidiary must find an available 1940 Act exemption or exception. The SEC considers advances or loans to other entities, including related companies, to be "securities" for purposes of the 1940 Act. Since most finance subsidiaries are funding conduits with no independent operations, they fail the 40% test set forth in Section 3(a)(1) of the 1940 Act and must use another available exemption or exception from the 1940 Act. Rules 3a-5, 3a-3 and 3a-7 and Sections 3(c)(1) and 3(c)(7) provide possible exemptions or exceptions from the 1940 Act for finance subsidiaries. In addition, Section 3(c)(5) provides an exception for certain sales finance subsidiaries.

Rule 3a-5

Rule 3a-5 is known as the "finance subsidiary" exemption. It was adopted by the SEC to avoid the definitional problem of the 1940 Act that otherwise would cause finance

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[406] If the finance subsidiary is an operating company, additional business and financial disclosure will be required.

[407] Rule 3-10 under Regulation S-X and Rule 12h-5 under the 1934 Act. Modified financial presentations may be permitted for wholly-owned operating companies enjoying a parent's unconditional guarantee. Separate 1934 Act reports are likewise not required in these circumstances.

[408] See Chapter 8 (*Exempt Offerings and Securities*).

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subsidiaries that are merely funding conduits to be subject to the 1940 Act. A finance subsidiary[409] must satisfy the following conditions in order to qualify under Rule 3a-5:

(1) any debt or preferred stock issued to or held by the public must be unconditionally guaranteed by its parent company;[410,411,412]

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[409] Paragraph (b)(1) of Rule 3a-5 under the 1940 Act requires that the finance subsidiary be a corporation, although the SEC staff has permitted limited liability companies, partnerships and business trusts meeting certain requirements and issuing certain types of non-voting securities to rely on the rule. See, *e.g.*, SEC No-Action Letters Inco Limited, available Mar. 4, 1994; Lehman Brothers, Inc., available Mar. 8, 1994 (relating to limited liability companies); Andrews & Kurth L.L.P., available Apr. 5, 1994 (relating to partnerships); Goldman, Sachs & Co., available Apr. 27, 1995; Merrill Lynch & Co., available May 25, 1995; and Lehman Brothers, Inc., available May 26, 1995 (relating to Delaware business trusts).

[410] The term "parent company" is defined in Rule 3a-5(b)(2) under the 1940 Act as an entity that is not an investment company under Section 3(a) of the 1940 Act or that is excepted or exempted by order from the definition of investment company by Section 3(b) of the 1940 Act or by rules adopted by the SEC under Section 3(a). Thus, the parent must be analyzed separately under the 1940 Act. Entities whose parents must rely upon an exemption from the 1940 Act under Section 3(c) (such as U.S. insurance companies, sales finance companies, broker-dealers and similar companies) may not be able to utilize Rule 3a-5, although exemptions from this aspect of Rule 3a-5 are often granted. See, *e.g.*, MetLife, Inc. and MetLife Capital Trust V (SEC Release No. IC-29101, File No. 812-13549 (Dec. 30, 2009) (notice); SEC Release No. IC-29124 (Jan. 26, 2010) (order); MBIA Global Funding, LLC (SEC Release No. IC-26751, File No. 812-12987 (Feb. 8, 2005) (notice); SEC Release No. IC-26785 (Mar. 17, 2005) (order)); LaSalle Funding LLC (SEC Release No. IC-25457, File No. 812-12706 (Mar. 11, 2002) (notice); SEC Release No. IC-25514 (Apr. 9, 2002) (order)); BHF Finance (Delaware) Inc. (SEC Release No. IC-25151, File No. 812-12596 (Sept. 6, 2001) (notice); SEC Release No. IC-25202 (Sept. 28, 2001) (order)); American International Group, Inc. et al. (SEC Release No. IC-24284, File No. 812-11714 (Feb. 10, 2000) (notice); SEC Release No. IC-24331 (Mar. 7, 2000) (order)); The Toronto-Dominion Bank, et al. (SEC Release No. IC-24258, File No. 812-11306 (Jan. 20, 2000) (notice); SEC Release No. IC-24289 (Feb. 15, 2000) (order)). Non-U.S. banks and non-U.S. insurance companies (unlike their U.S. counterparts) may be able to establish finance subsidiaries qualifying under Rule 3a-5. In addition, the parent company must be a private issuer, not a governmental entity. See Rule 3a-5(b)(2)(ii).

[411] Under certain circumstances, the 85% requirement may be interpreted on a cumulative rather than an offering-by-offering basis. See SEC No-Action Letter KDSM, Inc. and Sinclair Capital, available Mar. 17, 1997.

[412] The staff of the SEC has acknowledged that neither privately placed securities nor securities sold under Regulation S require a guarantee, even if the securities are eligible for resale pursuant to Rule 144A under the 1933 Act because such securities are not "issued to or held by the public" for purposes of Rule 3a-5(a)(1). See, *e.g.*, SEC No-Action Letters Societe Generale and SGA Societe Generale Acceptance, available Feb. 14, 1992; PSEG Capital Corporation, available July 13, 1988; Sony Capital Corporation, available Apr. 27, 1992; and MEC Finance USA Inc., available Oct. 25, 1991. In addition, the parent's requirements in the case of preferred stock are solely that it unconditionally guarantee payment of declared dividends and, in the event of liquidation, unconditionally guarantee the payment of the lesser of the full liquidation preference plus accumulated and unpaid dividends, or the amount of the subsidiary's assets remaining after the satisfaction of other parties having claims which, as a matter of law, are prior to those of the preferred stockholders. SEC No-Action Letters Cleary, Gottlieb, Steen & Hamilton, available Dec. 23, 1985; Chieftain International Funding Corp., available Nov. 3, 1992. For further explanation of the

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(2) at least 85% of the funds raised by the finance subsidiary must be invested in or loaned as soon as practicable, but in any event within six months after receipt, to its parent company or to another company controlled by its parent company;[413]

(3) the subsidiary does not invest in, reinvest in, own, hold or trade in securities other than U.S. government securities, securities of its parent company or an issuer controlled by its parent company, or commercial paper exempt under Section 3(a)(3) of the 1933 Act;[414]

(4) all of its common stock and other voting stock (other than directors' qualifying shares) must be owned, directly or indirectly, by an eligible parent company or a company controlled by its parent company;[415]

(5) the primary purpose of the subsidiary must be to finance the business operations of its parent company or companies controlled by its parent company;[416]

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requirement of a guarantee of preferred stock, see SEC No-Action Letter KDSM, Inc. and Sinclair Capital, available Mar. 17, 1997.

[413] The term "company controlled by a parent company" is defined in Rule 3a-5(b)(3) under the 1940 Act as any company that is more than 25% owned by the parent and, like the parent, is not an investment company under Section 3(a) or is excepted or exempted by order or by Section 3(b) or rules adopted by the SEC under Section 3(a). Entities which invest in or make loans to companies controlled by their parent company which fall within an exemption from the 1940 Act under Section 3(c) may not be able to utilize Rule 3a-5, although exemptions from this aspect of the rule are often granted. See, *e.g.*, J.P. Morgan Index Funding Company I, et al. (SEC Release No. IC-22713, File No. 812-10572 (June 17, 1997) (notice); SEC Release No. IC-22750 (July 15, 1997) (order)); American International Group, Inc. et al. (SEC Release No. IC-24284, File No. 812-11714 (Feb. 10, 2000) (notice); SEC Release No. IC-24331 (Mar. 7, 2000) (order)); LaSalle Funding LLC (SEC Release No. IC-25457, File No. 812-12706 (Mar. 11, 2002) (notice); SEC Release No. IC- 25514 (Apr. 9, 2002) (order)).

[414] The SEC staff has also permitted certain limited investments in demand and time deposits. See SEC No-Action Letter Hewlett-Packard Finance Company, available Oct. 7, 1992; see also IBM International Finance, N.V., et al. (SEC Release No. IC-19548, File No. 812-7917 (June 29, 1993) (notice); SEC Release No. IC-19602 (July 28, 1993) (order)). The SEC staff has also permitted certain limited investments in shares of money market mutual funds. See SEC No-Action Letter Hewlett-Packard Finance Company, available July 17, 1996.

[415] The SEC, however, has permitted a Netherlands Antilles entity to hold all of a finance subsidiary's common stock for the benefit of a charity. See Cellco Finance N.V. (SEC Release No. IC-23118, File No. 812-11108 (Apr. 20, 1998) (notice); SEC Release No. IC-23180 (May 12, 1998) (order)). The SEC staff stated that in certain limited circumstances a finance subsidiary would be permitted to have only one class of securities which would not be owned initially, or possibly ever, by the parent or a company controlled by the parent. See SEC No-Action Letter Brown & Wood, available Feb. 24, 2000 (although the parent would not own any securities of the business trust, it would control the entity in all material respects).

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(6) the parent company's guarantee must provide that in the event of a default in payment, the holders of the securities may proceed directly against the parent company; and

(7) any securities issued by the finance subsidiary which are convertible or exchangeable are convertible or exchangeable only for securities issued by the parent company or for debt securities or non-voting preferred stock issued by the finance subsidiary meeting applicable requirements of Rule 3a-5.

Some issuers are unable to take advantage of Rule 3a-5 because they have not used guarantees to enhance the credit of securities issued by their finance subsidiaries. For example, in lieu of guarantees, issuers have in the past either entered into a support or "keepwell" agreement with the finance subsidiary (discussed below) or entered into a reimbursement agreement with a bank that issues a letter of credit that backs the securities of the finance subsidiary. Although generally neither of the foregoing currently qualifies as a guarantee for purposes of Rule 3a-5, the rule provides that a letter of credit meeting certain prescribed conditions and issued by a parent that is a "foreign bank" under Rule 3a-6 under the 1940 Act may be used in lieu of a guarantee.[417]

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[416] Under Rule 3a-5 under the 1940 Act, a finance subsidiary may have business operations as long as such operations are subsidiary to its primary purpose of financing its parent. See SEC No-Action Letter KDSM, Inc. and Sinclair Capital, available Mar. 17, 1997.

[417] See Rule 3a-5(a)(7) under the 1940 Act. The SEC has also issued exemptive orders permitting alternatives to a guarantee. See, *e.g.*, FSA Capital Management Services LLC (SEC Release No. IC-25986, File No. 812-12704 (Mar. 28, 2003) (notice); SEC Release No. IC-26009 (Apr. 23, 2003) (order)); Cellco Finance N.V. (SEC Release No. IC-23118, File No. 812-11108 (Apr. 20, 1998) (notice); SEC Release No. IC-23180 (May 12, 1998) (order)); Bayerische Vereinsbank Aktiengesellschaft Vereinsbank Finance (SEC Release No. IC-21041, File No. 812-9340 (May 4, 1995) (notice); SEC Release No. IC-21102 (May 31, 1995) (order)); Berliner Handels-und Frankfurter Bank (SEC Release No. IC-19603, File No. 812-8232 (July 28, 1993) (notice); SEC Release No. IC-19649 (Aug. 24, 1993) (order)); WestLB Finance USA Inc. (SEC Release No. IC-18958, File No. 812-7888 (Sept. 16, 1992) (notice); SEC Release No. IC-19014 (Oct. 14, 1992) (order)); Berliner Handels-und Frankfurter Bank (SEC Release No. IC-15188, File No. 812-6309 (July 2, 1986) (notice); SEC Release No. IC-15230 (July 29, 1986) (order)) (where the subsidiaries' obligations were backed by a third-party arrangement with a Cayman Islands branch of the parent bank; the third party branch, and hence the parent itself, assumed the obligations of the finance subsidiaries when the proceeds from the sale of the obligations were loaned to or deposited in the branch and assigned to the holders of the obligations as security for the obligations). See also, AMBAC Capital Management, Inc. (SEC Release No. IC-21115, File No. 812-9286 (June 6, 1995) (notice); SEC Release No. IC-21182 (July 3, 1995) (order)) (parent corporation issued an unconditional insurance policy to back the obligations of its subsidiary; Southwestern Bell Capital Corporation (SEC Release No. IC-15388, File No. 812-6447 (Oct. 31, 1986) (notice); SEC Release No. IC-15430 (Nov. 21, 1986) (order)); Pactel Capital Resources (SEC Release No. IC-14964, File No. 812-6257 (Feb. 28, 1986) (notice); SEC Release No. IC-15014 (Mar. 25, 1986) (order)) (where the subsidiaries' obligations were backed by a support agreement enforceable directly by the holders of the obligation, and for regulatory reasons, the telephone companies could not guarantee subsidiary debt; the SEC viewed the support agreements as a satisfactory alternative).

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Rule 3a-3

A finance subsidiary may issue short-term paper (as defined in the 1940 Act) without a parent guarantee in reliance upon Rule 3a-3 under the 1940 Act. The commercial paper need not be privately placed (as is the case of commercial paper issued by a Rule 3a-5 finance subsidiary which does not have a parent guarantee), but the exemption limits the fund-raising options of the finance subsidiary to commercial paper. The pertinent conditions of Rule 3a-3 are generally as follows:

(1) all the issuer's outstanding securities (other than short-term paper, directors' qualifying shares and debt securities owned by the U.S. Small Business Administration) must be directly or indirectly owned by its parent; and

(2) the parent and its wholly-owned subsidiaries may have no more than 45% of their consolidated assets invested in, and receive no more than 45% of their consolidated net income after taxes from, investment securities.[418]

Rule 3a-7

Rule 3a-7 exempts any structured finance vehicle in the business of acquiring and holding virtually any type of asset (other than equity securities) that can be securitized, provided the vehicle satisfies conditions adopted by the SEC to protect investors.[419]

Section 3(c)(1)

Section 3(c)(1) provides an exception from the definition of "investment company" in the 1940 Act. A finance subsidiary meeting the qualifications of Section 3(c)(1) may issue securities without the restrictions that apply to private investment companies as to the type of securities offered. In order to qualify for the Section 3(c)(1) exemption, a finance subsidiary must satisfy the following conditions:

(1) its securities, other than short-term paper, may be beneficially owned by no more than 100 persons at any one time (after giving effect to the attribution provisions of the Section); and

(2) its securities must be sold in a private placement exempt from the provisions of the 1933 Act by virtue of Section 4(a)(2) or Regulation D.[420]

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[418] Under the rule, the parent must be a company that, among other things, meets the requirements of Rule 3a-1(a) under the 1940 Act. Section 3(b)(3) provides an exemption similar to Rule 3a-3 for an entity whose parent is an investment company as defined in Section 3(a) but that is excluded by Section 3(b).

[419] See Chapter 9 (1940 Act-Exempt Issuers).

[420] For additional information, see Chapter 9 (*1940 Act-Exempt Issuers*).

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Section 3(c)(5)

Sales finance companies are usually excepted from the provisions of the 1940 Act by Section 3(c)(5)(A) or (B), which exempt traditional finance companies.[421] As discussed in Chapter 9 (*1940 Act-Exempt Issuers*), Section 3(c)(5) is available not only for operating companies but also for many types of structured financings involving mortgages and other financial assets.

Section 3(c)(7)

Section 3(c)(7) excludes from the provisions of the 1940 Act any issuer whose securities are privately offered and are beneficially owned exclusively by persons who, at the time of their acquisition, are "qualified purchasers." The definition of "qualified purchaser" is set forth in Section 2(a)(51) of the 1940 Act and the SEC rules thereunder.[422]

SUPPORT AGREEMENTS

Support or "keepwell" agreements have been used (in lieu of a parent guarantee) by issuers to enhance the credit of a finance subsidiary. A support agreement is designed to provide comfort to investors and the rating agencies that the finance subsidiary will always have sufficient liquidity and solvency to pay its outstanding debts.

RATING AGENCY REQUIREMENTS

In order for a finance subsidiary to obtain a rating comparable to that of its parent from an NRSRO, the NRSRO may require a support agreement to include the following:

(1) the parent should maintain, directly or indirectly, at least 51% of the voting control over the finance subsidiary;

(2) the parent should cause the finance subsidiary to maintain a positive net worth;

(3) the parent should cause the finance subsidiary to maintain liquid assets at all times in an amount sufficient to pay its obligations as they become due;

(4) the support agreement should not be amended, modified or cancelled if doing so would result in a downgrade of the finance subsidiary's outstanding securities;

[421] As indicated above, traditional sales finance companies and mortgage banks that are themselves exempt from the 1940 Act by virtue of Section 3(c)(5) are generally prohibited from issuing securities through a special purpose finance subsidiary. See *supra* note 404.

[422] See Chapter 9 (1940 Act-Exempt Issuers).

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(5) holders of the finance subsidiary's securities should have the right, derivative (*i.e.*, through the finance subsidiary) or otherwise, to enforce the support agreement against the parent; and

(6) if the parent is a non-U.S. parent, it should consent to personal jurisdiction of U.S. courts in connection with its obligations under the support agreement.

In addition, the parent should qualitatively show a willingness to support the finance subsidiary, as demonstrated by the parent's history of providing financial support to its finance subsidiaries, the parent's reputation or brand risk linked to the finance subsidiary, the finance subsidiary's economic value to the parent, or other factors.

1933 ACT AND 1934 ACT REGISTRATION AND REPORTING ISSUES

If the parent of a finance subsidiary is not a reporting company under the 1934 Act, the SEC has generally required disclosure about the entities providing financial support. The SEC has not generally required such disclosure where the party providing the support files periodic information with the SEC under the 1934 Act (other than providing information pursuant to Rule 12g3-2(b), which applies only to foreign private issuers) because such information is publicly available to investors in the U.S. capital markets.

In connection with a proposed registration of investment grade non-convertible debt securities by a U.S. finance subsidiary of a non-U.S. parent, the SEC has advised us that the following analysis applies to such securities if the non-U.S. parent is eligible to use Form F-3.

The support agreement will not constitute a guarantee of the U.S. finance subsidiary's debt securities and therefore will not constitute a separate security of the parent requiring registration under the 1933 Act. The SEC will permit the U.S. finance subsidiary to register investment grade debt securities under the 1933 Act on Form S-3 pursuant to General Instruction I.C.2. The U.S. finance subsidiary's registration statement on Form S-3 can incorporate by reference a registration statement for the subsidiary filed under the 1934 Act on Form 10. The Form 10 registration statement should be filed prior to the registration statement on Form S-3 and should register the common stock of the U.S. finance subsidiary rather than any debt securities it may issue.

The sole registrant with respect to the 1934 Act and 1933 Act registration statements will be the U.S. finance subsidiary, and the only securities requiring registration under the 1933 Act will be the debt securities issued by the U.S. finance subsidiary. Full financial statements of the U.S. finance subsidiary audited in accordance with U.S. generally accepted accounting principles will be required to be included as part of the Form 10 registration statement. With respect to the U.S. finance subsidiary's ongoing reporting requirements

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under the 1934 Act, it will be required to file reports on Forms 10-K, 10-Q and 8-K as would any other U.S. issuer.[423]

In the case of a non-U.S. parent that enters into a support agreement for the benefit of an operating sales finance subsidiary that registers securities under the 1933 Act, the SEC will require disclosure of some nominal financial information on the non-U.S. parent if the parent is not a reporting company under the 1934 Act.

The SEC has exempted finance subsidiaries formed to issue debt securities or preferred stock from the periodic and current reporting requirements of the 1934 Act when the parent is a reporting company under the 1934 Act, the finance subsidiary is wholly-owned by the parent and has no independent operations, the parent has fully and unconditionally guaranteed all of the finance subsidiary's obligations under the outstanding securities and the holders of the securities may proceed directly against the parent to enforce the finance subsidiary's obligations.[424] The SEC has adopted Rule 12h-5 under the 1934 Act to exempt certain subsidiary issuers and subsidiary guarantors from the 1934 Act periodic reporting in cases where Rule 3-10 of Regulation S-X permits certain financial information relating to such subsidiary issuers and subsidiary guarantors to be omitted from registration statements or reports filed with the SEC.[425]

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[423] See SEC Release No. 33-8959 (Sept. 23, 2008) (http://www.sec.gov/rules/final/2008/33-8959.pdf). In preparing the 1934 Act registration statement on Form 10, the U.S. finance subsidiary can rely, by analogy, on Instruction I to Form 10-K in omitting certain information otherwise required by Form 10. The U.S. finance subsidiary's ability to rely on Instruction I will be contingent upon the satisfaction of the conditions set forth in Instruction I(1).

[424] However, as a condition to this position, the parent must include certain disclosure in its 1934 Act reports. See Rule 3-10 under Regulation S-X.

[425] See SEC Release No. 33-7878 (Aug. 4, 2000) (http://www.sec.gov/rules/final/33-7878.htm).

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CHAPTER 11

REITS

BACKGROUND AND HISTORY OF REITS 305
U.S. INTERNAL REVENUE CODE PROVISIONS 306
UPREITS AND DOWNREITS 307
REIT DEBT OFFERINGS 308
MORTGAGE OR SPECIALTY FINANCE REITS VS. EQUITY REITS 309
FUNDS FROM OPERATIONS 311

BACKGROUND AND HISTORY OF REITS

Real estate investment trusts ("REITs") were first authorized in the United States by the adoption of the Real Estate Investment Trust Act of 1960.[426] Prior to that time, most commercial real estate in the United States was held primarily in partnership form. By adopting the REIT legislation, Congress sought to bolster the many parts of the economy dependent on real estate by encouraging broader investor participation in real estate. The early REITs were similar to closed-end investment companies in that they were pools of assets advised by professional, third-party managers and did not pay corporate level taxes. Many of the earlier REITs, however, were plagued by conflicts of interest and other problems that resulted in a general lack of confidence in them by the investment community. As a result of the enactment of the Tax Reform Act of 1986, REITs were permitted to operate and manage most types of income-producing properties. This development permitted REITs to internalize their property management and development activities and eliminate some of the structural conflicts of interest that had undermined the confidence of the investment community.

In 1991, Kimco Realty Corporation completed an initial public offering and listed its shares on the NYSE. This was a watershed event for the REIT market since Kimco did not fit the general profile of REITs that had previously gone public. Kimco was a large, fully-integrated private real estate organization that operated as a "real" business and not as an entity created to hold a portfolio of properties managed by an external manager. Through its initial public offering, Kimco was able to establish a platform for ongoing access to the capital markets, pay down existing indebtedness, and provide liquidity for its existing investors. (Sidley Austin acted as underwriters' counsel on the Kimco initial public offering.) Other real estate organizations quickly followed Kimco by transforming themselves into REITs through initial public offerings. These REITs varied by property type and geographic focus. Investors' confidence in the REIT format was bolstered by the

[426] U.S. Internal Revenue Code Sections 856 through 859.

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willingness of these new REITs to adopt conservative debt policies and by the presence of a majority of independent members on boards of directors of REITs. REIT formation was further accelerated by the advent of the umbrella partnership REIT or "UPREIT," which is discussed below.

Since 2003, "qualifying dividends" paid by corporations that are themselves subject to taxation have been eligible to be taxed at reduced, capital gains rates.[427] Because REITs receive a dividends paid deduction that enables them to regularly bypass the corporate tax, a majority of REIT dividends (the most important exception being REIT dividends that are attributable to dividends the REIT receives from any "taxable REIT subsidiary") are generally ineligible for the reduced dividend rate. However, even on an after-tax basis at the maximum tax rates, REIT dividends on average continue to significantly exceed dividend levels of non-REITs. The reduced rate currently imposed on regular corporate dividends was made permanent by the American Taxpayer Relief Act of 2012.[428]

U.S. INTERNAL REVENUE CODE PROVISIONS

REITs are creatures of the Internal Revenue Code and are governed by a complex set of Internal Revenue Code provisions. In order to qualify as a REIT, among other requirements, a company must be formed as a corporation, business trust or similar vehicle, be managed by a board of directors or trustees and have at least 100 holders. In addition, shares of a REIT must be fully transferable and not more than 50% of a REIT's capital stock may be held by five or fewer individuals during the last half of the REIT's taxable year. For purposes of this "five-fifty" test, individuals include natural persons and certain entities, such as private foundations. REITs must also satisfy other tests, including:

- at least 90% of REIT taxable income must be distributed annually to holders;
- at least 75% of assets must be comprised of real estate assets (*e.g.*, real property, mortgage loans secured by interests in real property, etc.);
- at least 75% of REIT gross income must be comprised of rents from real property, interest on mortgage loans and certain other types of passive real estate-related income; and

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[427] On May 28, 2003, President Bush signed the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "JGTRRA") (P.L. 108-27).

[428] The maximum tax on qualifying dividends is currently 15% for married individuals filing joint returns and having taxable incomes of up to $450,000, and up to $425,000 in the case of unmarried individuals, and 20% to the extent that qualifying dividends exceed $450,000, in the case of married individuals filing joint returns and $425,000 in the case of unmarried individuals.

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- at least 95% of REIT gross income must be derived from the same items as the 75% income test and from passive investment sources such as dividends, interest and gain from the sale of securities.

A REIT must also satisfy certain other limitations on its assets. Ordinarily, a REIT cannot (1) invest more than 5% of its total assets in the securities of any one issuer, (2) invest more than 25% of its total assets in the securities of taxable REIT subsidiaries ("TRSs") or (3) own more than 10% (by vote or value) of any one issuer's securities (other than (i) wholly-owned entities treated as "qualified REIT subsidiaries" ("QRSs"), which are disregarded for federal income tax purposes and treated as part of the REIT that owns them and (ii) TRSs, subject to exceptions for certain debt instruments, notably including those that qualify as "straight debt" securities and any security issued by another REIT.)

The use of TRSs by REITs has become commonplace in REIT structures since laws permitting their use were adopted in 1999. A TRS can provide services (such as third-party management and development consulting) and hold assets (for example, oil and gas properties) without regard to the strict asset and income limitations placed upon REITs. A TRS is a corporation that is taxable as an ordinary corporation (that is, the TRS is subject to an entity-level income tax and its shareholders are subject to income tax on the dividends distributed by the TRS). In order for a corporation to qualify for TRS status, both the REIT and the corporation must file a joint election to treat the corporation as a TRS; a TRS need not be wholly-owned by a REIT.

One particularly notable type of TRS is one that leases a lodging facility or a health care facility from its parent REIT. The rent paid by the TRS to its parent REIT is deductible by the TRS in determining its corporate taxable income and is treated as "good" REIT income by the parent REIT, provided that the lodging facility or health care facility is managed on behalf of the TRS by an independent contractor that is also actively engaged in managing those types of facilities for parties unrelated to the REIT. The income derived directly from hotels and health care facilities is generally not treated as "rent" for REIT purposes but as business income. This type of TRS allows hotel REITs and health care REITs greater flexibility in their operations in that they do not have to lease those properties to an independent operator, but can merely hire one as a manager through a TRS.

UPREITS AND DOWNREITS

From inception through the early 1990s, REITs were formed as corporations or business trusts which then acquired properties or had properties contributed to them. In the latter case, this generally resulted in a taxable event for the parties contributing the properties, which was a significant impediment to REIT formation. In the early 1990s, the UPREIT structure was first employed. In this construct, a property owner contributes its assets to a newly-formed limited partnership (the operating partnership) in exchange for limited partnership interests in a tax-free exchange. The limited partnership's general partner is typically a REIT or wholly-owned subsidiary thereof. In one variation, a REIT may conduct an initial public offering and contribute the proceeds therefrom, either directly or through such a wholly-owned subsidiary, to the limited partnership in exchange for an

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interest in the limited partnership. The REIT lists its common stock on a national securities exchange (typically the NYSE) and the limited partnership interests held by parties that contributed real property are redeemable at the option of the holder for cash or, if the general partner so elects, exchanged for shares of common stock in the REIT. Since the exchange of properties for limited partnership interests is not a taxable event under the Internal Revenue Code, the UPREIT structure allows REITs to offer a significant tax deferral option to contributors who hold properties with substantial built-in gain.

Following the lead of the UPREITs, REITs that have not employed the UPREIT structure may utilize limited partnerships formed beneath the REIT in order to offer the same tax deferral benefits to a contributor and similar redemption and exchange rights as an UPREIT. This structure is sometimes referred to as a DOWNREIT.

In UPREIT and DOWNREIT transactions, the party contributing the property remains liable for the tax on the gain that was "built-in" to the property at the time it was contributed to the UPREIT or the DOWNREIT. Consequently, there is usually a "tax protection agreement" entered between the REIT and the property contributor at the time the property is contributed, in which the REIT agrees not to allow the UPREIT or the DOWNREIT to sell the contributed property for some contractually agreed period and to pay the property contributor's tax on the built-in gain if such a sale is made before the expiration of the agreed period. In addition, to avoid any taxable, deemed distributions to the contributor, the REIT may agree not to refinance the property except under certain circumstances.

REIT DEBT OFFERINGS

In attempting to access the debt capital markets, REITs have faced significant challenges in obtaining investment grade credit ratings. The rating agencies and the investment community have not forgotten the credit problems that highly leveraged REITs and other real estate vehicles experienced in the past. As a result, REITs have generally had to agree to a set of financial covenants in issuing debt securities in the public markets, even where their debt is rated investment grade. These covenants vary among REITs, but often include the following:

- limits on the incurrence of indebtedness as a percentage of the total assets of the REIT (including more stringent limits on the incurrence of secured debt);
- limits on the ratio of net income or funds from operations to the REIT's annual debt service payments;
- limits on distributions beyond those required by the Internal Revenue Code; and
- requirements regarding the maintenance of unencumbered assets.

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MORTGAGE OR SPECIALTY FINANCE REITS VS. EQUITY REITS

Some REITs hold mortgage-related debt investments as opposed to real property or a combination of mortgage-related debt investments and real property (so-called "hybrid REITs"). In addition to commercial or residential mortgage loans, mortgage or specialty finance REITs may hold a variety of other mortgage-related debt investments, such as mortgage-backed securities, mezzanine loans secured by pledges of all of the equity interest in the owners of real property, and debt securities issued by real estate companies or REITs. Many mortgage and specialty finance REITs are externally managed through a management agreement, similar to the way investment company funds are managed. The management agreement may contain provisions limiting the manager from managing similar vehicles and detailing the manner in which investment opportunities are allocated among affiliates of the manager and the REIT, and typically provides for a base management fee (*e.g.*, 1.75% of the REIT's equity per annum) and incentive compensation (*e.g.*, 20% of the REIT's net income or funds from operations over a specified return on the average price at which common shares have been sold in offerings by the REIT). UPREITs and DOWNREITs can be advantageous in this regard by having managers receive partnership interests that entitle them to the economic equivalent of incentive compensation in the form of a partnership profits interest, sometimes referred to as a "promote" or a "carried interest." In addition to potentially deferring their recognition of income, such an arrangement also may result in an allocation of partnership profits that are treated as capital gains.

Mortgage and specialty finance REITs generally seek to avoid registration under the 1940 Act, often by structuring themselves as holding companies that fall outside of the definition of "investment company" contained in Section 3(a)(1)(C) of the 1940 Act. Section 3(a)(1)(C) defines an investment company as any issuer that is "engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40% of the value of such issuer's total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis." Excluded from the term "investment securities," among other things, are U.S. government securities and securities issued by majority-owned subsidiaries that are not themselves investment companies and are not relying on the exception from the definition of investment company set forth in Section 3(c)(1) or 3(c)(7) of the 1940 Act. As a result, a mortgage or specialty finance REIT organized as a holding company may not own securities issued by subsidiaries that are excepted from the definition of "investment company" by Section 3(c)(1) or 3(c)(7) of the 1940 Act that, together with any investment securities, have a combined value in excess of 40% of the value of its total assets on an unconsolidated basis.[429]

Mortgage or specialty finance REITs operating through holding companies typically have one or more subsidiaries that are exempt from the 1940 Act by virtue of

[429] See also Chapter 9 (*1940 Act-Exempt Issuers*).

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Section 3(c)(5)(C), which provides an exemption for entities primarily engaged in the business of "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate."[430] For this purpose, the SEC has taken the view that, in order to qualify for this exemption, at least 55% of an entity's assets must consist of mortgage loans (or the functional equivalent) and other interests in real estate, commonly referred to as "Qualifying Real Estate Assets," and at least an additional 25% of the entity's other assets must be other qualifying real estate-related assets, or "Real Estate-Related Assets."

As a result of a May 2007 SEC no-action letter to Capital Trust, Inc. ("Capital Trust"), "Tier 1 mezzanine loans" may be treated as Qualifying Real Estate Assets where, except for the lack of a mortgage loan against the property, the mezzanine loan is the "functional equivalent" of, and provides the holder with the same economic position as a second mortgage (including providing the right to foreclose on the collateral and, thereby, through 100% ownership of the property-owning entity, ownership of the underlying real estate).[431] Other mezzanine loans are generally classified as Real Estate-Related Assets. Similarly, the Internal Revenue Service has issued guidance that mezzanine loans meeting certain requirements may be treated as loans secured by real property even though they are technically not so secured, being secured instead by ownership interests in an entity (typically a limited liability company) that owns real estate.[432]

Furthermore, as a result of the subsequent February 2009 SEC no-action letter to Capital Trust, B-Notes meeting specified conditions may also be treated as Qualifying Real Estate Assets.[433] The SEC staff (the "Staff") indicated that their position was based upon certain facts, including where the REIT has the unilateral right to: "(a) appoint the special servicer to manage the resolution of the loan; (b) advise, direct or approve the actions of the special servicer; (c) terminate the special servicer at any time with or without cause; (d) cure the default so that the mortgage loan is no longer non-performing; and (e) purchase the A-Note at par plus accrued interest, thereby acquiring the entire mortgage loan."[434] The Staff also noted in granting the no-action relief the following representations of Capital Trust: "(1) a B-Note is a participation interest in a mortgage loan that is fully secured by real property; (2) [Capital Trust] as B-Note holder has the right to receive its proportionate share of the interest and the principal payments made on the mortgage loan by the borrower, and that [Capital Trust's] returns on the B-Note are based on such payments; (3) [Capital Trust] invests in B-Notes only after performing the same type of due diligence and credit underwriting procedures that it would perform it if were underwriting the underlying

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430 *Id.*

431 *Capital Trust, Inc.*, SEC No-Action Letter (May 24, 2007) at Capital Trust, Inc. No-Action Letter (May 24, 2007).

432 Rev. Proc. 2003-65

433 *Capital Trust, Inc.*, SEC No-Action Letter (Feb. 3, 2009). Capital Trust, Inc. No-Action Letter (Feb 3, 2009).

434 *Id.*

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mortgage loan; (4) [Capital Trust] as B-Note holder has approval rights in connection with any material decisions pertaining to the administration and servicing of the loan and with respect to any material modification to the loan agreements; and (5) in the event that the loan becomes non-performing, [Capital Trust] as B-Note holder has effective control over the remedies relating to the enforcement of the mortgage loan, including ultimate control of the foreclosure process."[435] B-Notes not meeting the standards outlined above are generally treated as Real Estate-Related Assets.

SEC'S Concept Release and Review

While the SEC has addressed Section 3(c)(5)(C) on a case-by-case basis through staff no-action letters, it has not comprehensively addressed this statutory exclusion. The SEC has not expressed a view concerning whether other types of mortgage-related securities are Qualifying Real Estate Assets, Real Estate-Related Assets or neither, although certain mortgage and specialty finance REITs have disclosed their views on how they consider these securities in analyzing the availability of the exemption contained in Section 3(c)(5)(C). For example, with regard to CMBS, the general view taken by mortgage REIT registrants is that a mortgage REIT must own 100% of controlling class (bottom class) with, among other things, unilateral foreclosure rights; the controlling class and any contiguous non-investment grade class that is 100% owned is counted in the 55% Qualifying Real Estate Assets basket.

In August 2011, the SEC issued a concept release relating to the treatment under the 1940 Act of companies engaged in the business of acquiring mortgages and mortgage-related instruments. Specifically, the SEC is reviewing interpretive issues relating to the exclusion found in Section 3(c)(5)(C) of the 1940 Act and the types of assets that the exclusion permits. It is unclear what actions the SEC will take, if any, in this area. However, by issuing this concept release it is the intention of the SEC to avoid confusion amongst mortgage-related pools about when the exclusion applies. As a result, elements of the foregoing are subject to change.

FUNDS FROM OPERATIONS

When reporting financial results, many equity REITs report not only their net income but also their funds from operations, or "FFO." FFO is a measure that begins with net income calculated in accordance with GAAP and makes certain adjustments in an attempt to provide a more accurate measure of a REIT's performance. Historical cost accounting for real properties assumes that the value of such properties diminishes evenly over time and includes depreciation expense in calculating net income. Many analysts view net income as an insufficient measure of performance since real property values have risen or fallen with market conditions over time and the deduction for depreciation expense bears very little or no relationship to those values.

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[435] *Id.*

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It should be noted that FFO is a performance measure and not a measure of a REIT's cash flow. FFO is defined by the National Association of Real Estate Investment Trusts ("NAREIT") as "net income (computed in accordance with GAAP), excluding gains (or losses) from sales of property, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures. Adjustments for unconsolidated partnerships and joint ventures are calculated to reflect funds from operations on the same basis."[436] However, since FFO is a non-GAAP measure, some REITs have varied from the NAREIT definition. The SEC staff has indicated its intention to challenge such variations in the future.

Analysts often make adjustments to FFO to more adequately ascertain a REIT's true cash flow. Adjusted funds from operations, or "AFFO" (also known as cash available for distribution, "CAD," or funds available for distribution, "FAD"), measurements deduct recurring capital expenditures from FFO to arrive at a REIT's available cash flow. Typical recurring capital expenditures include: expenditures necessary to maintain the property, tenant improvement allowances, and costs associated with leasing. By deducting recurring capital expenditures from FFO, AFFO provides a more accurate measure of residual cash flow and, in turn, a more precise indication of a REIT's ability to pay dividends.

In light of the SEC's rules concerning the use of non-GAAP financial information, when disclosing FFO, REITs are required, among other things, to provide a reconciliation of FFO to net income and, for any document being filed with the SEC, to give equal or greater prominence to GAAP net income. SEC staff policy at one time strictly prohibited REITs from disclosing FFO per share in prospectuses and, as a result, press releases often disclose FFO on a per share basis while prospectuses (particularly those that are subject to SEC review, such as prospectuses for IPOs) typically do not disclose FFO per share.

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[436] NAREIT, *White Paper on Funds From Operations* (April 2002), pg. 2 (White Paper on Funds From Operations).

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CHAPTER 12

MASTER LIMITED PARTNERSHIPS

BACKGROUND 313
TYPICAL CAPITAL STRUCTURE 313
GOVERNANCE 316
U.S. FEDERAL TAX ASPECTS 317
STATE AND LOCAL TAXATION 318
POTENTIAL TAX REFORM 318

BACKGROUND

A master limited partnership (an "MLP") is typically a limited partnership with a publicly traded class of securities. The term "master" is historic, as the first MLPs were formed by rolling-up existing oil and gas drilling partnerships underneath a "master" limited partnership that issued securities to public investors. A characteristic feature of MLPs is that they are generally treated as partnerships for federal income tax purposes and therefore pay no federal income tax. Instead, their owners pay taxes on their shares of the MLP's income. As a result of this tax benefit, and the general flexibility of the partnership form of organization, by the mid-1980s, MLPs had become popular and were used by businesses varying as widely as professional basketball, amusement parks and farming.

In 1987, Congress sought to curtail the growth of MLPs by enacting a law that generally treated all publicly traded business entities as corporations for federal income tax purposes, unless they met a "qualifying income" test. Under this test, an MLP will be treated as a corporation unless it generates at least 90% of its gross income (as determined for federal income tax purposes) each year from certain qualifying sources. These qualifying sources include, and thus qualifying income includes, certain types of passive income, such as dividends, interest and real property rents. Qualifying income also includes income from certain natural resource-related activities—most typically centered around oil and gas—as well as fertilizer, geothermal and timber. Recently, qualifying sources have been expanded to include income from certain renewable fuels activities.

Today, there are over one hundred MLPs. While a number of these have structures differing from what is described here, they universally seek to generate stable cash flows from their businesses, distribute that cash flow to their partners and grow those distributions over time. With their focus on cash distributions to partners, MLPs are treated as yield-based securities by the marketplace.

TYPICAL CAPITAL STRUCTURE

MLPs are most often organized as limited partnerships, with limited partners rather than stockholders and a general partner instead of a board of directors.

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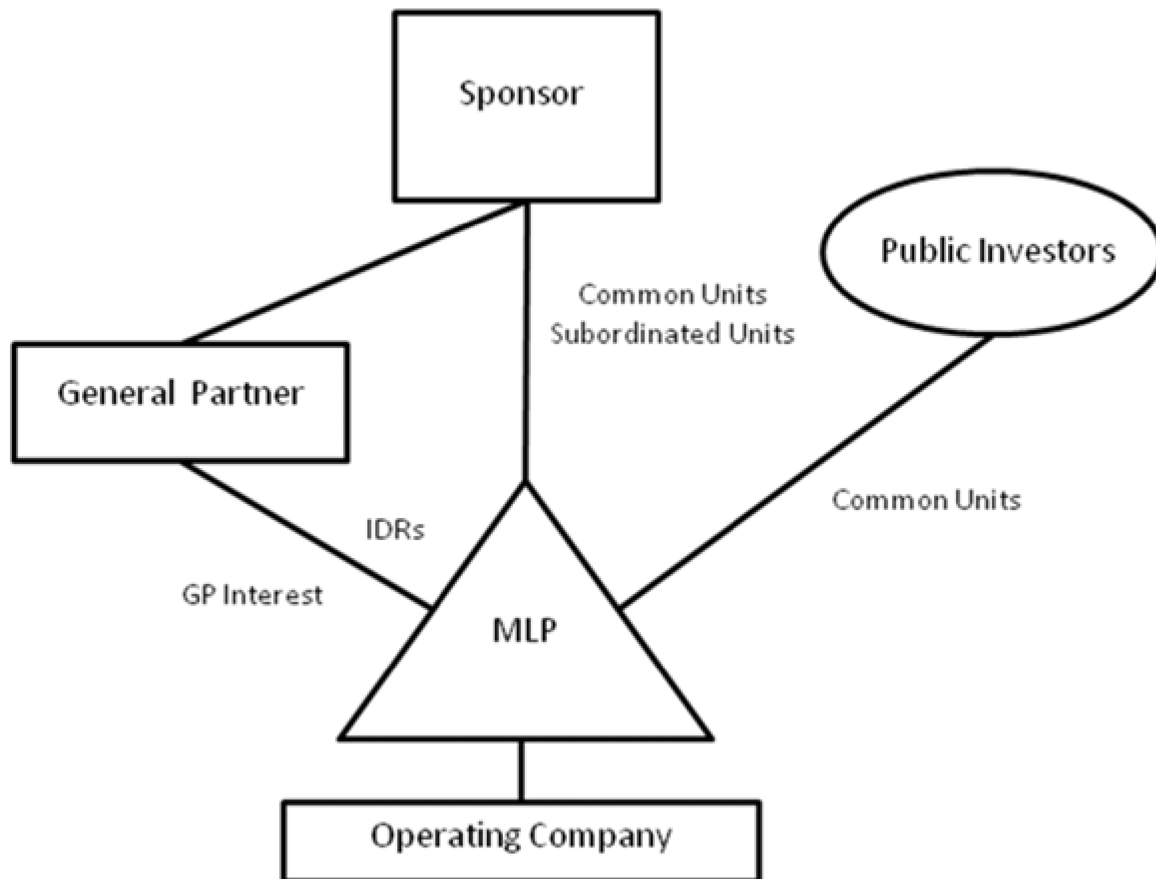
An MLP itself is generally structured as a holding company, with its assets held and operated by a wholly owned Delaware limited liability company. Most MLPs have no employees, instead relying on the board, officers and employees of the general partner. The diagram below illustrates the organization of a typical MLP.



Publicly Held Interests

Common Units

In the IPO of a typical MLP, public investors purchase common units of the MLP that represent limited partnership interests. An MLP's common units have limited distribution preferences (as described below) and are, from an economic perspective, akin to common stock in a corporation. They have limited voting rights. See "Governance" below.

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Sponsor's Interests

General Partner Interest

In many cases, a sponsoring company, private equity fund or group of individuals that decide to organize an MLP (the "Sponsor") will form a special purpose Delaware limited liability company to serve as the general partner of the MLP. As a general matter, an MLP's general partner will have complete discretion in the operation of the MLP.

Historically, the general partner of a typical MLP would own a 2% capital interest in the MLP and would participate (to the extent of its 2% interest) in all cash distributions paid by the MLP. More recently, some MLP general partners have held a non-economic capital interest in the MLP that does not share in cash distributions made by the MLP.

Subordinated Units

In order to assist in the successful marketing of the MLP's common units, the Sponsor will typically agree to subordinate the distribution rights of some of its retained limited partnership interests. In such cases, the Sponsor will hold subordinated units representing limited partnership interests.

Subordinated units are generally identical to an MLP's common units except that, during a subordination period, the common unitholders will have a preference over the subordinated unitholders in respect of any cash distributions made by the MLP. That is, the common unitholders must receive a minimum quarterly distribution (the "MQD") in cash on all common units before the subordinated unitholders are eligible to receive a cash distribution. Any shortfall in the distribution of the MQD on the common units is carried forward to future quarters and must be satisfied prior to the MLP making any distribution on the subordinated units for those future quarters. Subordinated units do not accrue any distribution arrearages.

Historically, the subordination period lasted for three to five years post-IPO, depending on the track record of the MLP in making cash distributions. More recently, some MLPs have been structured with subordination periods that expire after two or three years, without regard to the distributions made by the MLP. Following the expiration of the subordination period, the Sponsor's subordinated units become common units.

Incentive Distribution Rights

In addition to the foregoing classes of partner interests, the general partner will also typically own a limited partner interest referred to as "incentive distribution rights" (the "IDRs"), entitling it to increasing percentages, generally up to a maximum of 48%, of the cash distributed by the MLP in excess of a threshold. When the IDRs are paying out at the highest level, they are called the "high splits," a reference to the significant share of cash distributions that the general partner can receive after the distribution exceeds the highest threshold. As IDRs begin paying out only after the MLP has increased the level of its

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distributions well above the MQD, the IDRs serve to provide the general partner with an incentive to increase distributions over time.

Assuming the general partner holds a 2% general partner interest in addition to IDRs and there are no common unit arrearages, the typical MLP structure would provide for the following distribution splits.

		Marginal Percentage Interest in Distributions	
	Total Quarterly Distribution Per Unit Target Amount	Unitholders	General Partner
Minimum Quarterly Distribution	100% of MQD	98%	2%
First Target Distribution	MQD to 115% of MQD	98%	2%
Second Target Distribution	115% of MQD to 125% of MQD	85%	15%
Third Target Distribution	125% of MQD to 150% of MQD	75%	25%
Thereafter	Above 150% of MQD	50%	50%

Generally, a general partner has the right in certain circumstances to elect to relinquish the right to receive payments in respect of the IDRs that are based on the initial target distribution levels and to reset, at higher levels, the MQD and target distribution levels. In exchange for doing so, the general partner will typically receive a number of newly issued common units pursuant to a formula that takes into account the value of the average of the cash distributions related to the IDRs received by the general partner for the two quarters immediately preceding the reset event and the average of the cash distributions per common unit during that two-quarter period.

It is important to recognize that the capital structure of MLPs has developed over time, through negotiations between issuers and underwriters, and is not the product of any specific legal or tax constraint. Thus, while the foregoing represents a typical capital structure for an MLP, many variations are possible (and have occurred) in practice.

GOVERNANCE

The organizational structures employed by MLPs provide their Sponsors with significant post-IPO control. Where structured as a typical limited partnership, the Sponsor will own and control the MLP's general partner. An MLP's general partner is not elected and generally may be removed only in the limited circumstances described below. While the general partner typically will have a board of directors, because the Sponsor wholly owns the general partner, the Sponsor appoints all of the members of that board. SEC and exchange rules require some independent board members and an audit committee comprised (after a post-IPO phase-in period) of at least three independent members, but the common unitholders typically do not vote on the members of the board. The general partner may be removed by the unitholders, but only by the vote of 66 2/3% of the outstanding common units and subordinated units voting as a single class. Typically, the number of subordinated units and common units retained by the Sponsor at IPO afford it the ability to block any attempted removal of the general partner.

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Securities exchange rules generally exempt MLPs from a number of typical corporate governance requirements applicable to other public companies. For example, MLPs need not have a majority of independent board members or common board committees such as compensation and nominating committees. In most cases, unitholder approval is not required for equity issuances that lead to a change of control, exceed 20% of the outstanding units or are made to related parties.

U.S. FEDERAL TAX ASPECTS

Sponsors

As described above, MLPs are typically formed by the Sponsor contributing assets to the MLP in exchange for equity interests issued by the MLP. The MLP then concludes an IPO of common units to public investors. One beneficial tax aspect of forming an MLP is that the Sponsor may be entitled to receive a distribution of all or some portion of the cash proceeds invested by the public without recognizing taxable income.

Under the Internal Revenue Code, contributions to and distributions from a partnership generally do not result in the recognition of taxable income. A partner in a partnership recognizes gain on the receipt of a cash distribution from a partnership only to the extent the cash received exceeds the partner’s adjusted tax basis in its partnership interest. Thus, the Sponsor generally does not recognize any gain or loss as a result of the contribution of assets to an MLP, and recognizes taxable income on the receipt of a cash distribution from the MLP only to the extent the amount of the cash received exceeds the Sponsor’s tax basis in its equity interest in the MLP. For this purpose, the Sponsor’s initial tax basis in its MLP equity interest generally is equal to the tax basis in the assets contributed to the MLP. The Sponsor’s tax basis in its MLP equity interest thereafter will be increased to the extent the MLP allocates taxable income to the Sponsor and will be reduced to the extent the Sponsor receives distributions from the MLP.

An exception to the beneficial tax principles described above applies to contributions of property to, and distributions of cash from (or assumptions of debt by), a partnership that are treated as component parts of a “disguised sale” of the contributed assets. Treasury Regulations promulgated under the Internal Revenue Code generally provide that any cash distribution (or debt assumption) within two years of a property contribution may be treated as part of a disguised sale. However, these regulations also provide special categories of cash distributions and debt assumptions that will not be taken into account as payments of consideration for contributed property (and thus will not be treated as part of a disguised sale). Much of a Sponsor’s tax planning for an MLP IPO involves determining whether and to what extent it may receive a distribution of IPO proceeds without recognizing taxable gain.

Public Investors

Public investors who purchase common units in an MLP are treated as partners in a partnership for U.S. federal income tax purposes. As a result, they are required to take into

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account their shares of the MLP's income (or loss) each year as if they earned such income (or incurred such loss) directly. Thus, tax-exempt and non-U.S. investors, who would not normally be obligated to pay federal income taxes on income from some other investments in securities, generally are required to pay taxes on their shares of the MLP's income each year—and also may be obligated to pay such taxes on gain on sale of their MLP units.[437] The MLP provides year-end tax statements to each investor on a Schedule K-1, which reports to each individual partner the information they need to file their personal tax returns.

In determining the amount of taxable income required to be reported by an investor, MLPs employ special tax accounting principles that permit tax depreciation, depletion or amortization to be determined based upon the investor's purchase price for its MLP units. This generally results in the investor recognizing a greater amount of tax depreciation, depletion or amortization, and a lesser amount of taxable income, than would otherwise be the case if the investor were limited to its share of the tax basis in the MLP's assets. Due largely to this tax benefit, investors in MLPs generally report less taxable income each year while they own their MLP units than the amount of their cash distributions. The difference between the amount of cash distributions for a given year and the amount of taxable income recognized is referred to as the investor's "tax shield." Upon a sale of the investor's units, the investor may be required to "recapture" the tax shield benefit by recognizing taxable income equal to the tax deductions for depreciation or amortization previously taken into account (to the extent these deductions exceed the economic deterioration in value of the underlying assets).

STATE AND LOCAL TAXATION

Investors in MLPs generally are treated as doing business in each state where the MLP is doing business. As a result, investors may have tax return filing and payment obligations in many states by virtue of their MLP investments.

POTENTIAL TAX REFORM

There are various proposals in Congress to reform the federal income taxation of individuals and businesses. Some of these proposals could eliminate the current treatment of MLPs as partnerships for federal income tax purposes. Other proposals would simplify the taxation of all business entities and provide for a single unified system of business taxation, instead of the current system which distinguishes between entities treated as partnerships and entities treated as corporations. At the present time, it is unclear whether any such "fundamental" tax reform is likely to occur or what the timing and grandfathering would be if such reform were to occur.

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[437] MLPs generally are obligated to withhold federal income tax from distributions paid to non-U.S. investors. This tax withholding is generally satisfied by brokers who identify their customers as non-U.S. persons subject to withholding.

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In addition to fundamental tax reform proposals, more specific proposals have also been introduced in Congress that could affect the taxation of MLPs and their investors. Sen. Chris Coons, and co-sponsors, have introduced legislation that would expand the category of "qualifying income" to include certain "green energy" initiatives. This proposal has only experienced limited support to date, however. A proposal that has seen broader support, primarily aimed at taxing "carried interests" received by private equity and hedge fund managers as ordinary compensation income, would impose corporate income tax on publicly-traded partnerships that earn mainly passive income. However, this provision is not expected to affect most MLPs conducting operating businesses.

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CHAPTER 13

BANK ISSUERS

GENERAL 320
STATUS UNDER THE FEDERAL SECURITIES LAWS 323
1933 ACT CONSIDERATIONS 325
APPLICATION OF SECURITIES OFFERING REGULATIONS OF THE BANK REGULATORY AGENCIES 326
1934 ACT CONSIDERATIONS 327
1939 ACT CONSIDERATIONS 328
1940 ACT CONSIDERATIONS 329
BLUE SKY LAWS 329
FINRA CONSIDERATIONS 330

GENERAL

In this chapter, we address the issuance of securities in the U.S. capital markets by U.S. banks and U.S. branches and agencies of non-U.S. banks, which we collectively call "bank securities" and "bank issuers," respectively. Bank securities issued by bank issuers are exempt from 1933 Act registration by virtue of Section 3(a)(2) of the 1933 Act.[438]

Bank securities include senior or subordinated bank-level debt securities ("bank notes"), certificates of deposit structured to resemble debt securities ("deposit notes") and institutional certificates of deposit (which are certificates of deposit sold institutionally, generally through the intermediary of a deposit broker).

U.S. banks also access the U.S. capital markets at the holding company level and non-U.S. banks also access the U.S. capital markets directly and not through a U.S. branch or agency. In each case, the securities offerings are subject to the registration requirements of the 1933 Act and, if not registered with the SEC, are usually made pursuant to Section 4(a)(2) of, and Rule 144A or Regulation S under, the 1933 Act or, if commercial paper, Section 3(a)(3) or 4(a)(2) of the 1933 Act.

Both U.S. and non-U.S. banks are also frequent issuers of asset-backed securities and structured hybrid capital securities in the U.S. capital markets. However, such securities are usually issued by banks through trusts or other special-purpose vehicles, and are therefore not

[438] See Chapter 8 (*Exempt Offerings and Securities*).

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generally treated as "securities issued by a bank" for purposes of the federal securities laws. As a result, their issuance is subject to different considerations.[439]

For an overview of the U.S. regulations that apply to the activities of U.S. banks in the United States, see Appendix E (*Regulation of Activities of U.S. Banks in the United States*).

Characteristics of Bank Securities

Bank notes are general debt obligations of the issuing bank and may be issued as either senior debt ("senior bank notes") or subordinated debt ("subordinated bank notes") of the bank issuer. Senior bank notes are generally issued as either "short-term bank notes," with maturities from seven days to and including one year from the date of issuance, or "medium-term bank notes," with maturities of over one year. Short-term bank notes typically pay interest on a money market basis (actual/360) and, like commercial paper, are payable only at maturity. Medium-term bank notes typically pay interest at fixed or floating rates, using normal medium-term note interest conventions.

Although denominated "senior indebtedness," as a result of the depositor preference provisions of the Federal Deposit Insurance Act, as amended ("FDI Act"), senior bank notes issued by U.S. banks are subordinate in right of payment upon liquidation of the issuing bank to the U.S. deposit liabilities of such bank (including to the rights of the FDIC as subrogee of insured depositors of the bank).[440]

Subordinated bank notes rank subordinate in right of payment upon liquidation of the issuing bank to deposits and senior debt of the issuing bank, including senior bank notes. Subordinated bank notes are typically structured to qualify as Tier 2 capital under applicable bank capital regulations (*e.g.*, in the United States, five-year minimum maturity, minimal covenants, and acceleration only in the event a receiver is appointed for the bank).

Because bank notes are not deposits, they are not insured as deposits by the FDIC or any other governmental agency. As a result, U.S. bank issuers of bank notes are not required to include bank note liabilities in their assessment base when calculating the deposit insurance premiums, if any, payable to the FDIC on deposits.

Institutional Certificates of Deposit and Deposit Notes

Institutional certificates of deposit, which are sometimes referred to as brokered deposits, are deposit liabilities of the issuing bank and, accordingly, as a result of the depositor preference provisions of the FDI Act discussed above, in the case of U.S. banks,

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[439] For a general discussion of asset-backed securities and hybrid capital securities, see *Accessing the U.S. Capital Markets – Securities Products*.

[440] 12 U.S.C. Section 1821(d)(11).

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rank senior in right of payment upon liquidation of the issuing bank to such bank's senior bank notes and subordinated bank notes. Although they are insured deposits, and therefore subject to inclusion in an insured bank's FDIC insurance assessment base, they are typically sold in denominations significantly in excess of the FDIC insurance limit ($250,000 per beneficial owner[441]) with the result that investors rely on the credit of the issuing bank, not the availability of FDIC insurance, in making their decision to invest in such instruments.

Under applicable provisions of the FDI Act and the FDIC's regulations thereunder, only "well capitalized" U.S. depository institutions and "adequately capitalized" U.S. depository institutions that have received the prior approval of the FDIC may issue brokered deposits.[442]

Under the International Banking Act of 1978 (the "IBA") (subject to certain limited exceptions), non-U.S. banks may accept deposits having balances of less than the standard maximum deposit insurance amount (as determined in accordance with the FDI Act) only through FDIC-insured U.S. banking subsidiaries or U.S. branches that were FDIC-insured on December 19, 1991 and remain FDIC-insured.

Regulation D

Bank notes, deposit notes and institutional certificates of deposit, if not payable solely outside the United States, are generally subject to Regulation D[443] of the Federal Reserve Board. The Federal Reserve Board's Regulation D imposes reserve requirements on any liability (whether or not it is classified as a deposit for FDIC insurance purposes), including any liability evidenced by a bank note, deposit note or institutional certificate of deposit, that is a non-personal time deposit, transaction account or eurocurrency liability.[444] However, the

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[441] Section 335 of the Dodd-Frank Act permanently increased the standard maximum deposit insurance amount to $250,000 per depositor. The FDIC issued a final rule in August 2010 making conforming amendments to the FDIC's regulations to reflect this statutory change. See Deposit Insurance Regulations; Permanent Increase in Standard Coverage Amount; Advertisement of Membership; International Banking; Foreign Banks, 75. *Fed. Reg*. 49,363 (Aug. 13, 2010). All funds in a "noninterest-bearing transaction account" were insured in full by the FDIC through December 31, 2012. This temporary unlimited coverage was in addition to, and separate from, the $250,000 per-depositor amount. The term "noninterest-bearing transaction account" includes a traditional checking account or demand deposit account on which the insured depository institution pays no interest. It also includes Interest on Lawyers Trust Accounts ("IOLTAs"). It does not include other accounts, such as traditional checking or demand deposit accounts that may earn interest, NOW accounts and money-market deposit accounts.

[442] 12 U.S.C. Section 1831f and 12 C.F.R. Section 337.6.

[443] 12 C.F.R. Part 204.

[444] It should be noted, however, under revisions to the Federal Reserve Board's Regulation D, and as originally authorized by the Financial Services Regulatory Relief Act of 2006, the Federal Reserve Board pays interest on balances held by or on behalf of depositary institutions. See http://www.federalreserve.gov for more information.

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reserve requirement for non-personal time deposits and eurocurrency liabilities is currently set at zero.[445]

Equity-Linked and Credit-Linked Securities

The issuance of equity-linked and credit-linked bank notes, deposit notes and certificates of deposit and other "structured" bank notes, deposit notes and certificates of deposit present unique issues under U.S. securities, banking and commodities laws, which should be considered by any bank that is contemplating issuing such instruments.[446]

STATUS UNDER THE FEDERAL SECURITIES LAWS

The initial consideration under the federal securities laws is whether the instrument being issued constitutes a "security." The 1933 Act and the 1934 Act define a "security" to include any note, bond or debenture, evidence of indebtedness and any certificate of deposit for a security.

Bank notes would clearly constitute "securities" under this definition. The status of deposit notes and institutional and other certificates of deposit under these definitions is less clear. In Marine Bank v. Weaver, 455 U.S. 551 (1982), the U.S. Supreme Court held that the certificate of deposit considered in that case was not a security for purposes of the anti-fraud provisions of the 1934 Act. The court based its holding on its conclusion that holders of the certificate of deposit were "abundantly" protected by the comprehensive set of regulations governing the banking industry and therefore did not need the protection of the federal securities laws. The court, however, acknowledged that certificates of deposit could be considered securities in certain cases, noting that each transaction must be analyzed "on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole."

Subsequent to Marine Bank, several courts have ruled that certificates of deposit issued by non-U.S. banks were not "securities" for 1933 Act purposes.[447] The primary determinant in each of these cases was the courts' finding that home country regulation reduced the risk of the certificate of deposit so as to render the protections of the U.S.

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[445] The Dodd-Frank Act eliminated Regulation Q of the Federal Reserve Board, which had prohibited depositary institutions having world-wide assets in excess of $1 billion from paying interest on demand deposits, which are defined to include liabilities with an original maturity or required notice of withdrawal period of less than seven days. The effect of Regulation Q had been to prohibit bank issuers from issuing bank notes, deposit notes and institutional certificates of deposit with original maturities of less than seven days.

[446] For more information on structured notes, see Chapter 7 of *Accessing the U.S. Capital Markets – Securities Products*.

[447] See, *e.g.*, *Wolf v. Banco Nacionale de Mexico, S.A.*, 739 F.2d 1458 (9th Cir. 1984), cert. denied, 469 U.S. 1108 (1985); *West v. Multibanco Comermex, S.A.,* 807 F.2d 820 (9th Cir. 1987), cert. denied, 482 U.S. 906 (1987).

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securities laws unnecessary. These cases suggest that whether non-U.S. bank certificates of deposit are considered "securities" for federal securities law purposes will be highly dependent on the nature of banking regulation in the bank's home country.

In Gary Plastic Packaging Corporation v. Merrill Lynch, Pierce, Fenner & Smith Inc., 756 F. 2d 230 (2d Cir. 1985), the U.S. Court of Appeals for the Second Circuit upheld and refused to grant a motion to dismiss a claim that brokered deposits considered in that case would be "securities" within the meaning of the 1934 Act. At issue in Gary Plastic was a program developed by Merrill Lynch to sell bank certificates of deposit to the public (the "program"). The certificates of deposit were in denominations of $100,000, the then-maximum denomination for which FDIC insurance had been available. Under the program, Merrill Lynch chose the banks in which to place customer monies, based upon its assessment of the creditworthiness of the bank and the yield of the certificate of deposit. Merrill Lynch also monitored the banks for continuing creditworthiness on a regular basis, marketed the certificates of deposit, and maintained a secondary market in the certificates of deposit. No other secondary market for the certificates of deposit existed at that time; a holder of certificates of deposit requiring liquidity before the stated maturity date would be required to pay an early withdrawal fee to the issuing bank. The plaintiffs brought suit on the basis of, among other things, Sections 5(a) and 17 of the 1933 Act, Section 10(b) of the 1934 Act and Rule 10b-5 under the 1934 Act, asserting that the certificates of deposit were created especially for Merrill Lynch customers, that the rates on the certificates of deposit were lower than the rates on certificates of deposit ordinarily offered by the banks, and that Merrill Lynch retained the difference between the rates as an undisclosed commission.

The Second Circuit upheld the refusal to grant a motion to dismiss and, based upon the plaintiff's allegations (which, on a motion to dismiss, are assumed to be true), found the certificates of deposit were securities for purposes of the anti-fraud provisions of the 1933 Act and the 1934 Act. The Second Circuit concluded that the certificates of deposit were securities because (i) plaintiffs invested money in the certificates of deposit, (ii) "[b]y investigating issuers, marketing the [certificates of deposit], and creating a secondary market, Merrill Lynch was engaged in a common enterprise," and (iii) plaintiffs' investments in the certificates of deposit were based on an expectation of a return of cash investment, potential price appreciation, and the liquidity of the certificates of deposit, all of which would be derived from the efforts (and continued solvency) of Merrill Lynch. The court also observed that the certificates of deposit constituted investment contracts and that Merrill Lynch's role in the program was significantly greater than that of an ordinary broker in that, in addition to the other elements of a common enterprise, Merrill Lynch negotiated rates of interest with the issuing banks (which, as stated above, allegedly were lower than the rates paid directly by such banks).

Consideration needs to be given to Gary Plastic in determining whether a broker-placed certificate of deposit or deposit note is a "security" under the federal securities laws. However, as further discussed below, even if a certificate of deposit or deposit note is deemed to be a "security," it should, if issued by a U.S. bank or a U.S. branch or agency of a non-U.S. bank, generally be exempt from the registration requirements of the 1933 Act.

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1933 ACT CONSIDERATIONS

U.S. Banks

Section 3(a)(2) of the 1933 Act exempts from the registration and prospectus delivery requirements of the 1933 Act "any security issued or guaranteed by a bank."[448] Accordingly, bank notes, deposit notes and institutional certificates of deposit of national and state-chartered banks are generally exempt from the registration and prospectus delivery requirements of the 1933 Act.

U.S. Branches and Agencies of Non-U.S. Banks

The 1933 Act does not specifically address the availability of the Section 3(a)(2) exemption in the case of a branch or agency of a non-U.S. bank. However, in 1986, the SEC issued a release (the "1986 Release") formalizing its position, previously taken in a series of no-action letters, that "for purposes of the exemption from registration provided by Section 3(a)(2) of the 1933 Act, the SEC deems a branch or agency of a non-U.S. bank located in the United States to be a 'national bank' or a 'banking institution organized under the laws of any State, Territory, or the District of Columbia,' provided that the nature and extent of Federal and/or State regulation and supervision of the particular branch or agency is substantially equivalent to that applicable to Federal or State chartered domestic banks doing business in the same jurisdiction."[449] As a result of the 1986 Release and its own analysis of the regulation of non-U.S. branches and agencies in the United States, counsel for issuing U.S. branches and agencies of non-U.S. banks are generally able to conclude that securities of such branches and agencies are exempt from the registration requirements of the 1933 Act.

Direct Issuances by Bank Holding Companies

Securities issued by a bank holding company are generally subject to registration under the 1933 Act, unless an exemption (such as the exemption set forth in Section 4(a)(2) of the 1933 Act for privately-placed securities or in Section 3(a)(3) for commercial paper) is available. The private placement and commercial paper exemptions to the 1933 Act's registration requirement are further discussed in Chapter 8 (*Exempt Offerings and Securities*).

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[448] For purposes of the 1933 Act, "bank" is defined to include "any national bank, or any banking institution organized under the laws of any state, territory or the District of Columbia, the business of which is substantially confined to banking and is supervised by the state or territorial banking commission or similar official."

[449] SEC Release No. 33-6661, 1 Fed Sec. L. Rep (CCH) 2024A (Sept. 23, 1986).

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APPLICATION OF SECURITIES OFFERING REGULATIONS OF THE BANK REGULATORY AGENCIES

Although exempt from registration under the 1933 Act, securities issued by bank issuers are potentially subject to the registration and prospectus delivery requirements of the applicable federal and state bank regulatory agencies.

OCC Regulations

Under the Securities Offering Disclosure Rules of the Comptroller of the Currency,[450] national banks and federally-licensed branches and agencies of non-U.S. banks are subject to the registration and prospectus delivery requirements of the Office of the Comptroller of the Currency ("OCC") unless an exemption from such requirements is available. The exemptions from registration generally mirror those contained in the 1933 Act (including the private placement and commercial paper exemptions), with the exception that the 3(a)(2) exemption for bank-issued securities is not available.

The OCC's Securities Offering Disclosure Rules generally require that a bank subject to the rules register securities with the OCC on the same form that it would use if it were required to register securities under the 1933 Act. In recognition of the fact that most banks that are subsidiaries of bank holding companies do not compile, on a bank-level basis, the information that would be required to comply with comparable SEC registration statement forms, the OCC Securities Offering Disclosure Rules provide an alternative abbreviated registration procedure for sales of non-convertible debt securities. In order to qualify for use of the abbreviated registration procedure, the issuing bank must be a subsidiary of a bank holding company that has securities registered under the 1934 Act, or have securities registered under the 1934 Act, the debt securities must be sold to accredited investors in minimum denominations of $250,000, and the non-convertible debt securities being offered must be investment grade. A security is "investment grade" if the issuer of the security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. To meet this standard, national banks must determine that the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected.[451]

If the offering qualifies for the abbreviated registration procedure, then the information in the offering circular can be limited to a description of the terms of the debt security and the use of proceeds, and can incorporate by reference the bank's latest call reports and the bank's or the bank holding company's Forms 10-K, 10-Q and 8-K filed under the 1934 Act.

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[450] 12 C.F.R. Part 16.

[451] Pursuant to directives of the Dodd-Frank Act, the OCC has adopted final rules, effective January 1, 2013, eliminating the former requirement that the non-convertible debt security be rated "investment grade" by at least one NRSRO. 77 Fed. Reg. 35255 (June 13, 2012).

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In order to use the abbreviated registration procedure, federally-licensed branches and agencies of non-U.S. banks are not required to have securities registered under the 1934 Act or be subsidiaries of reporting companies under the 1934 Act if the federal branch or agency provides the OCC with the information specified by Rule 12g3-2(b) under the 1934 Act and provides purchasers with the information specified in Rule 144A(d)(4)(i) under the 1933 Act.

In contrast to registration statements generally filed under the OCC Securities Offering Disclosure Rules, there is no requirement that the offering circular used under the abbreviated registration procedure for federally-licensed brokers and agencies of non-U.S. banks be formally declared effective by the OCC. It is sufficient that the offering circular and any amendments be filed with the OCC no later than the fifth business day after first use.

Although the OCC's Securities Offering Disclosure Rules purport to require registration of any instrument that is a "security" as defined in the 1933 Act, the preamble of the regulations states that "the OCC does not intend the definition to cover insured and uninsured deposit products or other traditional bank products, including letters of credit, bankers' acceptances and repurchase agreements."[452] The OCC staff has opined that certain "deposit notes" would not be considered "securities" subject to registration under the Securities Offering Disclosure Rules.[453]

Federal Reserve Board and FDIC

The Federal Reserve Board does not have comparable securities offering regulations for state-chartered banks that are members of the Federal Reserve System. However, some states require banks that they charter to register their securities with the applicable state banking regulator. In addition, the FDIC has issued a "Statement of Policy on the Use of Offering Circulars" with respect to securities of state-chartered banks that are not members of the Federal Reserve System (the "Statement of Policy").[454] The Statement of Policy generally requires that state non-member banks use an offering circular containing the information set forth in the Statement of Policy when offering their securities. However, it does not require the offering circular be filed with or declared effective by the FDIC.

1934 ACT CONSIDERATIONS

It is important for potential issuers to recognize that even if a bank security is exempt from registration under the 1933 Act, sales of such a security are generally subject to the anti-fraud provisions of Section 10(b) of the 1934 Act and Rule 10b-5 thereunder, which make it unlawful for any person, in connection with the sale of a security, to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the

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[452] 59 Fed. Reg. 54789, 54791 (Nov. 2, 1994).

[453] OCC Interpretive Letter No. 922 (Dec. 13, 2001).

[454] 61 Fed. Reg. 46807 (Sept. 5, 1996).

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statements, in the light of the circumstances under which they were made, not misleading. Furthermore, sales of bank securities are generally subject to state anti-fraud provisions. As a result, detailed offering circulars for bank note and deposit note programs are normally prepared, even when such preparation is not explicitly required by applicable federal or state banking regulation. In the case of U.S. banks, such offering materials tend to mimic the disclosure used by national banks under the OCC's Securities Offering Disclosure Rules. Offering circulars of state-licensed branches and agencies of non-U.S. banks, particularly non-U.S. banks accessing the U.S. capital markets for the first time, tend to be more fulsome. Such offering circulars frequently contain or incorporate by reference 1934 Act filings of the non-U.S. bank and a full description of the non-U.S. bank, as well as financial statements and statistical information similar to that required in 1933 Act registration statements by Industry Guide 3 (Statistical Disclosure by Bank Holding Companies).[455]

In addition, because underwriters of bank securities are also subject to liability, even when such securities are exempt from registration under the 1933 Act, they will generally conduct "due diligence" of the issuing bank in order to avoid liability and often require accountants' comfort letters or agreed upon procedures letters and 10b-5 statements of counsel to support due diligence.

1939 ACT CONSIDERATIONS

The 1939 Act requires that publicly-offered debt securities be issued under an indenture with an independent trustee to enforce the rights of securityholders. Under Section 304(a)(4)(A) of the 1939 Act, no indenture need be qualified with respect to any security that is exempt from registration under Section 3(a)(2) of the 1933 Act. The securities offering regulations of the federal bank regulatory agencies generally do not impose a requirement for a trust indenture. Accordingly, it is generally not necessary to qualify an indenture under the 1939 Act or applicable federal regulations with respect to bank debt securities that are exempt from registration under the 1933 Act. Although, for market-driven reasons, such securities are sometimes issued under indentures whose provisions resemble those of 1939 Act-qualified indentures, they are more often issued under issuing and paying agency agreements that do not contain the detailed covenants normally contained, or the extensive trustee obligations required, in a 1939 Act-qualified indenture and that may require each holder to act independently with respect to matters affecting such holder's interests, including giving written notice of default on the notes and accelerating the note's maturity following an event of default. Many banks act as their own issuing and paying agent under such agreements, while others prefer for ease of administration to retain other institutions to perform this function.

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[455] See http://www.sec.gov/about/forms/industryguides.pdf.

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1940 ACT CONSIDERATIONS

The 1940 Act imposes registration requirements on entities deemed to be "investment companies." Because of the SEC's position that loans are "securities" under the 1940 Act, banks must find an exemption from the 1940 Act before issuing bank notes, deposit notes or other securities in the United States.

U.S. banks and U.S. branches and agencies of non-U.S. banks[456] are generally excepted from the definition of "investment companies" under the 1940 Act by Section 3(c)(3) of the 1940 Act. Section 2(a)(5) of the 1940 Act defines the term "bank" to include "(A) a depository institution (as defined in Section 3 of the FDI Act) or a branch or agency of a foreign bank (as such terms are defined in Section 1(b) of the IBA), (B) a member bank of the Federal Reserve System, (C) any other banking institution or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks and which is not operated for the purpose of evading the provisions of … [the 1940 Act]…."

BLUE SKY LAWS

If the securities of a bank issuer are deemed to be "securities" under the 1933 Act and therefore exempt from registration by reason of Section 3(a)(2), such securities will be deemed to constitute "covered securities" pursuant to Section 18(b)(4)(C) of the 1933 Act ("18(b)(4)(C) Covered Securities"). As such, the securities registration requirements under the blue sky laws of the states are preempted with respect to the offer and sale of such securities. As a result, state requirements regarding securities registration, merit review, and the imposition of disclosure requirements on any offering document that is prepared by "or on behalf of the issuer" of the securities in question are preempted with respect to the offer and sale of covered securities, including 18(b)(4)(C) Covered Securities.

If the bank issuer has other securities outstanding which are listed on the NYSE, NYSE MKT, NASDAQ Global Select Market, NASDAQ Global Market, Nasdaq Capital Market (but not the NASDAQ OTC Bulletin Board), or on certain other national securities exchanges set forth in Rule 146 under the 1933 Act, and the securities being offered are "equal in seniority" or constitute a "senior security" to such listed securities, the security

[456] While Section 3(c)(3) of the 1940 Act does not by its terms exempt non-U.S. banks (as distinct from their U.S. branches and agencies) from registration as investment companies, the SEC has issued Rule 3a-6 under the 1940 Act, which exempts "foreign banks" as defined in the rule from being considered as investment companies under the 1940 Act. A non-U.S. bank that does not meet the above definition may seek an order from the SEC exempting it from being considered an investment company pursuant to Section 6(c) of the 1940 Act, although such orders tend to be time consuming and difficult to obtain.

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being offered would also qualify as a covered security pursuant to Section 18(b)(1)(C) of the 1933 Act ("18(b)(1)(C) Covered Securities").

The states are permitted to impose a filing requirement in respect of an offering of 18(b)(4)(C) Covered Securities "solely for notice purposes" and which notice can consist of no more than a cover letter, a limited consent to service of process of the issuer, and a filing fee (the amount of the filing fee varies from state to state). The filing is generally required to be perfected prior to the commencement of the offering in the applicable state. In many states, a filing is not required if the issuer can rely on a self-executing exemption from securities registration that would be available for the offering under such state's blue sky law if such state's securities registration requirement were not preempted. Under many states' blue sky laws, a self-executing exemption is available in respect of securities issued by national or state banks, although it is not clear if these exemptions would necessarily include securities issued by U.S. branches of non-U.S. banks, even if the U.S. branch is subject to federal or state regulation similar to that of a national or state bank.

The states are not permitted to impose any filing requirement in respect of an offering of 18(b)(1)(C) Covered Securities.

FINRA CONSIDERATIONS

If the bank securities are being offered and sold through broker-dealers that are members of FINRA, and such instruments constitute "securities" under the 1933 Act, the offering will be subject to the requirements of FINRA Rule 5110, including a required filing thereunder prior to the commencement of the offering. Pursuant to FINRA Rule 5110(b)(9)(F), securities offered by a bank are subject to FINRA Rule 5110, including its filing requirement, even though such securities may be exempt from registration under the 1933 Act.

FINRA Rule 5110 generally requires that the terms of an offering in which FINRA members are participating as underwriters or selling agents, as well as the compensation paid to such FINRA members, be "fair and reasonable," as more fully set forth in such rule.

If (i) the instruments in question are rated by an NRSRO (such as Standard & Poor's, Moody's or Fitch) in one of its four highest generic rating categories or (ii) the issuer (a) has unsecured, non-convertible debt with a term of at least four years or (b) has unsecured, non-convertible preferred securities, in each case, rated by an NRSRO in one of its four highest generic rating categories, the offering will be exempt from having to be filed with FINRA under FINRA Rule 5110, although the other requirements of such rule will still be applicable.[457]

[457] See FINRA Rules 5110(b)(7)(B) and (A).

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If an exemption from filing is not available, copies of the offering materials, selling agreements, and certain other information must be filed with, and approved by, FINRA prior to the commencement of the offering together with a filing fee of $500 plus 0.015% of the aggregate dollar amount of the securities being offering, with a maximum filing fee of $225,500; the maximum filing fee triggers at an offering amount of $1.5 billion.

If one of the FINRA member-selling agents has a "conflict of interest" in respect of the public offering, as defined in FINRA Rule 5121(f)(5), the offering will be subject to FINRA Rule 5121. A "conflict of interest" would result, for these purposes, if (a) the securities are to be issued by a FINRA member, (b) the issuer controls, is controlled by or is under common control with the FINRA member or the FINRA member's associated persons, (c) at least five percent (5%) of the net offering proceeds are directed to the FINRA member, its affiliates or associated persons or (d) as a result of the public offering and any transactions contemplated at the time of the public offering, the FINRA member will be an affiliate of the issuer, the FINRA member will become publicly owned or the issuer will become a FINRA member or form a broker-dealer subsidiary.

If a "conflict of interest" exists, there must be "prominent disclosure" of the nature of the conflict of interest in the prospectus, offering circular or similar document. Such "prominent disclosure" is made by (A) providing the notation "(Conflicts of Interest)" following the listing of the Plan of Distribution in the Table of Contents section, and by providing such disclosures in the Plan of Distribution section and any Prospectus Summary section required in SEC Regulation S-K or (B) for an offering document not subject to SEC Regulation S-K, by providing disclosure on the front page of the offering document that a conflict exists, with a cross-reference to the discussion within the offering document and in the summary of the offering document if one is included. Further, no member which has a "conflict of interest" may confirm sales of the securities to discretionary accounts without the prior specific written approval of the customer.

Finally, if a "conflict of interest" exists, a "qualified independent underwriter" (a "QIU"), as defined in FINRA Rule 5121(f)(12), must participate in the preparation of the applicable offering circular pertaining to the securities and must exercise the "usual standards of 'due diligence' in respect thereto" unless (a) the FINRA member primarily responsible for managing the public offering does not have a conflict of interest, is not an affiliate of any FINRA member which has a conflict of interest and meets the requirements of FINRA Rule 5121(f)(12)(E) relating to "bad actor" disqualifications, (b) the securities offered have a "*bona fide* public market" as defined in FINRA Rule 5121(f)(3) or (c) the securities offered are "investment grade rated" as defined in FINRA Rule 5121(f)(8).

If the instruments in question do not constitute "securities" under the 1933 Act, FINRA Rule 5110 and FINRA Rule 5121 should not be applicable. If the instruments in question do not constitute "securities" under the 1933 Act, FINRA Rule 5110 and NASD Rule 2720 should not be applicable. Notwithstanding the foregoing, however, FINRA has stated that FINRA members involved in the marketing of bank-issued certificates of deposit should understand the characteristics and risk factors associated with such instruments before soliciting customers to purchase such instruments. As such, FINRA recommends that

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members review their compliance programs, supervisory procedures, and continuing education programs to ensure that their registered persons are properly trained and educated about such instruments. See NASD Notice to Members ("NTM") Number 02-69. In addition, NASD NTM 02-69 sets forth certain disclosures that should be provided to prospective investors "sufficiently in advance" of the transaction date.

If the issuer proposes to market its instruments directly to investors without using a 1934 Act-registered broker-dealer, there could be broker-dealer registration issues for the issuer's employees/agents/representatives under the 1934 Act as well as broker-dealer and issuer-agent/salesman registration issues for the issuer and its employees/agents/representatives, respectively, under the various states' blue sky laws.

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CHAPTER 14

INSURANCE COMPANY ISSUERS

GENERAL....333
STOCK INSURANCE COMPANIES....333
MUTUAL INSURANCE COMPANIES....334
RECIPROCAL INSURANCE EXCHANGES....335
MUTUAL INSURANCE HOLDING COMPANIES....336
STATE-BASED REGULATION....336
DUE DILIGENCE AND DISCLOSURE....340
FEDERAL SECURITIES LAWS AND CERTAIN INSURANCE PRODUCTS....343

GENERAL

Life insurance companies and property and casualty insurance companies raise capital through a wide variety of traditional, as well as more industry-specific, financing mechanisms. The need for insurance companies to secure additional funding for their internal operations, growth and adherence to a myriad of regulatory requirements has been, and continues to be, a major contributor to the many innovations that the insurance industry and the capital markets have seen in recent years.

In addition to the various laws and regulations applicable to an insurance company, the company's size, financial strength and organizational form often influence the manner in which an insurance company will attempt to meet its capital needs. From a corporate structural perspective, there are three general categories of insurance companies: stock insurance companies, mutual insurance companies and reciprocal insurance exchanges. A fourth form of insurance company is a mutual insurance holding company, which is a hybrid structure that retains elements of the mutual form at the holding company level, but in which the insurance company is a stock company. The corporate structure of an insurer can affect the manner in which the insurer accesses the capital markets.

STOCK INSURANCE COMPANIES

Insurance companies, like other corporate issuers, are subject to the federal and state securities laws. When any company issues securities, it must either register the securities with the SEC or it must issue them pursuant to an exemption from registration under the 1933 Act. With a stock insurance company, equity interests are held by common stockholders. The common stock may be registered with the SEC and publicly traded or it may be privately issued and traded in transactions that are exempt from the registration requirements of 1933 Act and the ongoing reporting requirements of the 1934 Act. A stockholder of a stock insurance company may, but need not, own any insurance products issued by the company. In the United States, the majority of property and casualty insurance

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companies as well as most life insurance companies are organized as stock insurance companies.

Typically, a stock insurance company's common stock is owned by a parent holding company which is not itself an insurance company. In these cases, the holding company instead of the insurance company may issue debt, equity and hybrid securities. Insurance holding companies generally access the institutional investor market when conducting private placements by adhering to the requirements of Rule 144A of the 1933 Act. The funds generated by the holding company's issuance of these securities can either be used to fund obligations or initiatives of the holding company or be contributed to its subsidiary insurance company to help finance the insurer's operations or satisfy its regulatory capital requirements. Repayment of the holding company debt securities is complicated by the regulation of dividends payable by the insurer subsidiary. For instance, most states limit an insurer's dividends to the greater of (in some states, the lesser of) 10% of the insurer's surplus or the preceding year's net gain from operations.

Additional financing opportunities exist for both stock insurance companies and their parent holding companies. For example, stock insurance companies themselves may issue debt, hybrid and equity securities to investors in either SEC-registered or Rule 144A transactions. As discussed in more detail below, many jurisdictions permit stock insurance companies to issue a special type of hybrid security, known as a surplus note.

While parent holding companies do not have the option of issuing surplus notes, both holding companies and stock insurance companies generally have available all of the traditional debt and equity financing tools at the disposal of any non-insurance corporation. In addition to being able to issue common stock and traditional corporate debt, these companies often issue preferred stock and hybrid securities.

MUTUAL INSURANCE COMPANIES

Mutual insurance companies are owned by their policyholders, rather than third-party shareholders, and are typically not reporting companies under the 1934 Act.[458] These companies do not have the ability to issue common stock or any other traditional form of equity securities. Instead, they may sell (among other products) insurance policies which have a participation feature. The participating policies typically provide that, in addition to the receipt of policy benefits under the specific policy purchased, the participating policyholder receives profits of the insurer in the form of dividends and the policyholder may exercise voting rights in connection with matters traditionally reserved for stock insurance company shareholders. Additionally, if the insurance company were to be liquidated, these participating policyholders, much like the equity holders of a stock company, would have the

[458] However, some mutual insurance companies that sell products such as variable annuities and other types of variable products that are considered securities for purposes of the federal securities laws may have reporting obligations under the 1934 Act.

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right to receive any residual assets of the insurance company after satisfaction of all its liabilities.

Because mutual insurance companies cannot raise capital through the issuance of equity securities, they are more limited in financing alternatives than their stock insurance company counterparts. In most cases, the primary financing tool used by mutual insurance companies that is the closest equivalent to a common stock offering is the issuance of surplus notes. In the event a mutual insurance company has downstream subsidiaries that are public companies, an additional capital raising method would be for its downstream public subsidiary to issue securities (including common stock) and dividend the proceeds to its parent mutual insurance company.

As mentioned above, a mutual insurer may issue surplus notes. Surplus notes are typically offered privately. They bear interest at a specified rate until a stated maturity date and, upon maturity, the principal amount of the surplus notes becomes due. To achieve regulatory treatment as surplus, two basic requirements must be satisfied. First, surplus notes must be long-term unsecured debt obligations of the issuing insurance company that rank *pari passu* with each other, but must remain subordinate to the claims of policyholders and all other indebtedness of the insurance company. Second, payments of interest or principal with respect to surplus notes must first be approved by the insurance regulator of the issuing insurance company's state of domicile. Some regulators take the position that such approval can take the form of a standing order giving prior approval to all payments in a given time period so long as an insurer has a minimum amount of capital. Conversely, many regulators require an actual contemporaneous request prior to any payments, which is consistent with applicable statutory accounting guidelines. In some cases, the regulator may only approve a portion of the proposed payment. Payments under the surplus notes do not become legal obligations until the requisite regulatory approval has been received. Consequently, the failure to receive regulatory approval for any payment (or portion thereof) does not constitute an event of default. Furthermore, interest may not accrue on interest payments that have not been approved. While there is no definitive regulatory guidance as to whether any surplus note payment is likely to be approved by the relevant regulator, the overall financial health of the issuing insurance company is certainly a key factor in the regulator's determination.

RECIPROCAL INSURANCE EXCHANGES

A reciprocal insurance exchange is an unincorporated association formed to provide insurance coverage to its members. Each member of the association assumes the risk of the other members. Profits and losses are shared in direct proportion to how much insurance coverage a member has. The arrangement is somewhat similar to the mutual insurance company structure, in that it is owned by the insureds, and places premium dollars that are received into a pool, which is used to pay claims. Reciprocal insurance exchanges consist of two components: the reciprocal inter-insurance exchange, and the attorney-in-fact. The exchange is the actual risk bearer. The attorney-in-fact is a separate legal entity that is selected by the governing body of the exchange and is the contractually authorized manager of the reciprocal which administers and manages the reciprocal's day-to-day operations.

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MUTUAL INSURANCE HOLDING COMPANIES

Mutual insurance holding companies provide a blend of corporate features seen with stock and mutual companies. This structure retains elements of the mutual form but provides a more flexible capital structure than a traditional mutual insurance company.

Mutual insurance holding company structures generally consist of the parent mutual holding company, an intermediate holding company and one or more stock insurance companies. Generally, the policyholders of the insurance company own the membership interests of the mutual holding company. Through ownership of the membership interests, the policyholders may exercise voting rights in matters traditionally reserved for equity owners of stock companies. This structure allows for security issuances at the intermediate holding company. Capital can be raised by the issuance of debt, hybrid securities (including surplus notes by the stock insurance companies) or, subject to the limitations described in the next sentence, equity securities from either the intermediate holding company or any of its stock insurance company subsidiaries. Typically, a mutual insurance holding company must hold directly or indirectly at least a majority of the outstanding shares of the stock insurance company. These issuances of either unsecured debt or equity may be made pursuant to private placements or via SEC-registered offerings.

STATE-BASED REGULATION

Historically, the business of insurance has been regulated on a state-by-state basis. Therefore, each state (and the District of Columbia) has its own statutes, regulations and interpretations governing both insurance companies domiciled within the state as well as insurance companies domiciled in different jurisdictions which offer or sell any of their insurance products within the state’s boundaries.

While the ability of each individual state to enact and enforce its own statutes, regulations and interpretations governing the insurance industry has tended to result in a lack of conformity in approach, the efforts of the National Association of Insurance Commissioners (“NAIC”) have helped standardize certain areas of insurance law. The NAIC is a voluntary organization whose membership is comprised of the leadership of the insurance departments of the 50 states, the District of Columbia and five United States territories. As one of its primary functions, the NAIC drafts and proposes “model acts” that relate to certain areas of insurance regulation. In an effort to increase consistency among the states, the NAIC proposes these model acts and works with the various states to create a sample set of statutes that is acceptable and ultimately adopted by as many states as possible. The NAIC also promotes standardized accounting for insurance companies. While the efforts of the NAIC have promoted the standardization of insurance regulations, there is still a vast array of regulatory approaches among the states.

The rules and regulations enacted by the various states are designed, at a most basic level, to promote the sound financial condition and solvency of the relevant insurance companies, fair competition and, ultimately, the interests of policyholders. In 1945, the McCarran-Ferguson Act was enacted to specifically restrict the federal government from

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regulating the business of insurance. However, federal law may still regulate certain activities of insurers that go beyond the "business of insurance," such as the issuance of securities. Some of the significant state regulatory issues which participants in capital market offerings should understand are described below.

Statutory Accounting vs. GAAP

Insurance companies are required to prepare financial statements in accordance with statutory accounting principles ("SAP") as adopted in the applicable state. Typically, SAP focuses on the liquidation (as opposed to going concern) value, and tends to provide a more conservative representation of the financial condition of an insurance company than would result from the application of GAAP. SAP focuses on the solvency of the insurer. For example, under SAP accounting, the assets of an insurance company are classified as either "admitted assets" or "non-admitted assets". Admitted assets are assets that the insurance company's state of domicile have determined can readily be converted into cash, while non-admitted assets cannot. SAP does not include the value of non-admitted assets and, as a result, non-admitted assets do not count towards the insurance company's regulatory capital requirements. Because state regulators require both stock and mutual insurance companies to use SAP, many insurance companies which do not issue SEC-registered securities prepare their financial statements only in accordance with SAP. Therefore, private offerings of securities undertaken by a company that does not produce GAAP financial statements include the company's financial information based on SAP and generally include a comparison of the differences between SAP and GAAP financial statements.

Change of Control Filings

Generally, the direct or indirect acquisition of 10% or more of the voting securities (or any securities convertible into voting securities) of an insurance company will trigger the Form A filing and prior approval requirements under the provisions of the Insurance Holding Company Act of the insurer's state of domicile. If, in connection with an offering of securities of an insurer or the direct or indirect parent company of an insurer, a party or group of parties acting in concert acquires a certain threshold (typically 10% or more) of the voting securities (or any securities convertible into voting securities) of the insurer, then a filing with, and the prior approval of, the insurer's domestic insurance regulator will be required. The purchaser's Form A statement is required to contain certain information regarding the purchaser, including financial information and biographical information with respect to the purchaser's officers and directors, detailed information concerning the consideration used to acquire the securities, the purchaser's future plans, a description of the transaction and copies of the related agreements and other information required by the applicable statute or regulation or requested by the insurer's domestic insurance regulator. In certain states, prior to approval being granted, a hearing will be required by statute or at the direction of the regulator. In several states, the applicable Insurance Holding Company Act exempts securities brokers performing no more than the usual and customary broker's function from the acquisition and control filing and approval requirements.

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Blue Sky Securities Laws

In addition to traditional state securities (or "blue sky") laws, state insurance codes may include specific insurance securities laws. These types of laws are very similar to traditional state securities laws but may not include all of the registration exemptions currently included in traditional state "blue sky" laws.

Federal Regulation and the Optional Federal Charter

The existence of different insurance regulators in every state has been a hallmark of the United States' insurance industry. With different insurance regulatory bodies existing and independently acting in each state and with the ever-growing number of products being offered by insurance companies, some critics have argued that the insurance regulatory scheme in the United States is far too complex, unnecessarily burdensome and, ultimately, inefficient. In response to the recent financial crisis, the Federal Insurance Office ("FIO") was established by the Federal Insurance Office Act of 2010 (the "FIO Act"), which is Subtitle A of Title V of Dodd-Frank. The FIO is housed in the Department of the Treasury and is headed by a Director who is appointed by the Secretary of the Treasury. While the FIO serves an important role by providing necessary expertise and advice regarding insurance matters to the Treasury Department and other federal agencies, it is not a regulatory agency and its authorities do not displace the state insurance regulatory regime.

The FIO is authorized to perform functions including the following with respect to all lines of insurance (excluding health insurance, certain long-term care insurance and crop insurance): (1) monitoring the insurance industry, including identifying gaps in the regulation of insurers that could contribute to systemic crisis in the insurance industry or in the U.S. financial system; (2) monitoring the extent to which traditionally underserved communities and consumers, minorities and low- and moderate-income persons have access to affordable insurance products; (3) recommending to the Financial Stability Oversight Counsel ("FSOC") that certain insurers be subject to regulation as a threat to the financial stability of the United States in the event of their material financial distress, or based on the nature, scope, size, scale, concentration, interconnectedness or mix of activities; (4) assisting in administering the Terrorism Insurance Program established under the Terrorism Risk Insurance Act of 2002; (5) coordinating Federal efforts and developing Federal policy on prudential aspects of international insurance matters, including representing the United States in the International Association of Insurance Supervisors and assisting the Treasury Secretary in negotiating certain agreements between the United States and one or more foreign governments, authorities or regulatory entities regarding prudential measures with respect to the business of insurance or reinsurance (each such agreement, a "covered agreement"); (6) determining whether State insurance measures are preempted by covered agreements; (7) consulting with States and State insurance regulators regarding insurance matters of national and international importance; (8) advising the Treasury Secretary on major domestic and international insurance policy issues and agreements between the United States and other foreign governments; and (9) monitoring all aspects of the insurance sector, including identifying activities within the sector that could potentially contribute to a systemic crisis with respect to the broader financial system, the extent to which under-served communities

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have access to affordable insurance products and the sector's regulation. The Director of the FIO serves as a non-voting member of the FSOC. The Director also plays a role in the resolution of certain troubled insurance companies.

In order to carry out these functions, the FIO is authorized to receive and collect data and information on the insurance industry and can enter into information sharing agreements with State insurance regulators. The FIO can also require an insurer or its affiliate to submit data to the FIO; however, the FIO must first determine whether any public or regulatory sources are available before requiring such information directly from an insurer. The FIO Act provides an exemption for small insurers that meet a minimum size threshold at the date of this publication not yet defined by the FIO. A primary function of the FIO is to issue several one-time reports as well as annual reports to Congress. The FIO's "Study and Report on the Regulation of Insurance" in the United States has not yet been released at the date of this publication. The deadline for the report was eighteen months following enactment of Dodd-Frank (or on January 23, 2012).

Dodd-Frank Orderly Liquidation Authority

Title II of Dodd-Frank ("Title II") created the Orderly Liquidation Authority ("OLA"), an insolvency regime that gives the FDIC power to place systemically important United States financial companies into receivership in order to preserve the stability of the U.S. financial system.

To be placed into receivership under OLA, an entity must be a "covered financial company," as defined under Title II. A company must satisfy two criteria in order to be a "covered financial company." First, the company must be a "financial company," as defined under Title II. Second, the Secretary of the Treasury must determine that failure of the company would pose a systemic risk to the financial stability of the United States. Due to the systemic risk requirement, only large financial companies will be candidates for orderly liquidation. Only a few of the largest U.S. insurance companies are likely to satisfy the systemic risk requirement necessary for receivership under OLA.

The defining feature of liquidation under OLA is the amount of authority and discretion given to the FDIC as receiver. Once liquidation commences, court oversight over FDIC action becomes very limited. The FDIC controls the claims process, with the ability to allow and value claims against the covered financial company. Title II limits the ability of affected parties to challenge unfavorable actions by the FDIC. Upon commencement of an OLA proceeding, the FDIC acquires the power to operate all of the company's businesses. The FDIC has the ability to dispose of a company's assets through a merger or sale of assets or through the creation of a bridge financial company. The FDIC can modify obligations of the company and has the authority to reject any contract or lease if the company has ongoing obligations under it.

Most financial companies placed into receivership by the Secretary of the Treasury will be liquidated by the FDIC using the insolvency regime created by OLA. However, insurance companies are treated differently from other financial companies under Title II and

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are always liquidated under state insurance law. Following an order placing an insurance company into receivership, the insurance company's state insurance regulator has sixty days to commence receivership under state law.[459] If the state regulator fails to act within sixty days, the FDIC is authorized to stand in for the state regulator as receiver.[460] However, the FDIC must still apply state insurance law as receiver. The powers of the FDIC under OLA do not apply to liquidations of insurance companies under any circumstances.

DUE DILIGENCE AND DISCLOSURE

Due Diligence

In addition to the general business, financial, accounting and legal due diligence concerns that are typically addressed in any traditional securities offering, investors in an insurance company's securities have a number of other items to consider.

A key area of focus of due diligence is the insurance company's relationship with its relevant regulators. Investigation of the company's recent regulatory filings and communications with its regulators may identify significant developments in the insurance company's business, financial condition or accounting controls.

Understanding the adequacy of the insurance company's reserves is another important step in the due diligence process. Reserves are a liability of an insurance company which are required to be established and reported to ensure an insurance company has sufficient assets available to meet its obligations to policyholders. Disclosure regarding insurance company reserves (particularly in the context of an SEC-registered offering where the establishment of reserves is often deemed to involve critical accounting estimates) is often quite robust. With respect to property and casualty insurance companies, due diligence investigations into the appropriateness of the company's case reserves, loss adjustment reserves and incurred but not reported ("IBNR") claim reserves is often conducted. With respect to life companies, the reserves for many products are formulaic; however, those conducting due diligence should understand the insurer's product offerings in order to identify whether external forces—such as the stock market—may impact the life company's reserves.

Review of the insurer's investment portfolio is critical. As discussed in more detail below, a thorough review of an insurance company's investments is vital to understanding and evaluating the financial condition and profitability of the insurance company.

Another major area of due diligence involves the insurer's complaint files. Review of these files can help determine whether the insurer may face adverse trends or developments with respect to its policyholders, such as class action litigation or regulatory investigations.

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[459] 12 U.S.C. § 5383(e)(3).

[460] *Id.*

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A comfort letter from the insurance company's independent auditor addressing the company's financial statements is typically requested by the underwriter in connection with an underwritten offering of securities by an insurance company. The comfort letter of an insurer that produces GAAP financial statements addresses concepts typically encountered by comfort letters relating to issuers that are not insurance companies. The comfort letter of an insurer that only prepares SAP financial statements focuses on compliance with SAP rather than any comparison to GAAP requirements. In either case, comfort letters relating to insurance companies should address the audited and interim financial statements as well as certain financial metrics as of dates and for periods subsequent to the most recent financial statements.

In addition to the foregoing, another major area of due diligence with respect to life insurance companies involves the insurer's deferred acquisition costs ("DAC"). These costs are related to the acquisition of new insurance business, such as commissions, certain costs associated with policy issuance and underwriting, and certain sales support expenses, and are deferred when incurred. To ensure that the insurer's financial statements comply with GAAP's revenues and expenses matching principle, the costs associated with the acquisition of new insurance business is spread out over the period in which revenues are earned in connection with such business. Under FAS 97 and FAS 120, the insurer makes assumptions regarding the deferral of costs based on estimates of prospective revenues and makes adjustments to DAC as needed. The unamortized balance of DAC is treated as an asset on the insurer's balance sheet and amortized over the life of the insurance contract or new business acquired. A write-off or amortization of DAC may be accelerated by "dynamical unlocking," a process by which assumptions are replaced by experience for projections of revenues in future time periods. In connection with dynamical unlocking, the insurer will perform a true-up process, whereby assumed values are replaced by realized values of the applicable time period. In assessing the profitability of an insurer's business, it is important to conduct due diligence concerning how the insurer's business is performing in respect of underlying assumptions relating to DAC and whether any dynamical unlocking is anticipated.

Disclosure

Company-specific disclosure for insurance companies is similar in many respects to company-specific disclosure seen in a traditional SEC-registered or private placement offering by a non-insurance company issuer. Insurers or insurance holding companies issuing SEC-registered securities must adhere to the federal securities law requirements in the same fashion as other types of issuers. For private offerings, like other types of issuers, insurers and insurance holding companies generally follow the requirements of Regulation S-K of the 1933 Act. While the disclosure associated with a capital markets transaction within the insurance industry typically contains many of the same items included in similar corporate transactions, there are some industry-specific items that are necessary.

An insurance company's offering document typically includes a business description and MD&A. Among other items in a typical insurance company business description, there will be a discussion of the company's business and the products it sells (including a

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discussion of any general trends or conditions affecting its business or products). The MD&A will typically include a detailed discussion of the manner in which the company values certain assets and liabilities. The company's results of operations and investment results for the previous three years (including comparisons between successive years and breakdowns of investments by category, rating and type of investment) and a discussion of the company's year-end balance sheet for the previous two years is also commonly found in an insurance company's MD&A. Additionally, a discussion of certain capital raising and other financing activities and future plans of the company, a summary of certain contractual obligations and contingent commitments of the company and a description of any off-balance sheet transactions entered into by the company are usually included.

In connection with preferred stock or registered debt offerings, Regulation S-K requires that registration statements filed on either Form S-1 or S-3 contain an exhibit showing a company's ratio of earnings to fixed charges. This ratio may be calculated differently for insurance companies than for other types of corporations because an insurance company's obligations under certain insurance products may be required to be presented as fixed charges.

Insurance company offering documents also contain detailed disclosure with respect to the insurance company's reserves. The disclosure typically includes the types of reserves maintained by the company, such as loss adjustment expenses or IBNR. The insurer usually discusses the methodology of establishing the reserves, which may vary by line of business. For property and casualty insurers, Regulation S-K requires the insurer to disclose the loss reserve developments for each of the ten previous years.

Another important feature of insurance company disclosure relates to investments because such a large portion of an insurance company's operations involves its investment portfolio. This disclosure also typically includes a discussion of the investment portfolio's "other than temporary impairments." Such a discussion includes the method for determining when asset write-downs must occur and the amount of those write-downs for the covered financial reporting periods. This disclosure usually shows other than temporary impairments in a number of ways, such as by asset class, ratings and age of impairment. Given the current economic environment, currently this disclosure often contains a discussion regarding certain troubled asset classes, which may include sovereign bonds, mortgage-backed securities or other asset-backed securities that the insurance company has in its investment portfolio. The Division of Corporation Finance of the SEC recently published guidance relating to disclosure pertaining to European sovereign bonds in CF Disclosure Guidance: Topic No. 4 European Sovereign Debt Exposures dated January 6, 2012 (the "CF Disclosure Guidance"), which sets forth the Division of Corporation Finance's belief that disclosures relating to European sovereign bonds should be provided separately by country, segregated between sovereign and non-sovereign exposures, and by financial statement category, to arrive at gross funded exposure, as appropriate. Further, according to the CF Disclosure Guidance, registrants should also consider separately providing disclosure of the gross unfunded commitments made. The Division of Corporation Finance suggested in the CF Disclosure Guidance that registrants provide information regarding hedges in order to present an amount of net funded exposure.

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FEDERAL SECURITIES LAWS AND CERTAIN INSURANCE PRODUCTS

Insurance companies, particularly life insurance companies, issue a variety of products that are considered securities and thus subject to the federal securities laws. As in any other financial services context where securities are being offered and sold, brokers and producers of insurance products that are deemed to be securities must possess appropriate broker-dealer or other licenses. If an insurance product is deemed a security, it is subject to both insurance and securities law regulation. Certain products issued by insurance companies, however, cannot be easily characterized as securities. Section 3(a)(8) of the 1933 Act addresses the applicability of the federal securities laws with respect to a number of insurance products, including life insurance policies, fixed annuities, variable annuities and indexed annuities.

Section 3(a)(8)

Section 3(a)(8) of the 1933 Act provides an exemption for insurance products that are not deemed securities and, therefore, are exempt from registration under the 1933 Act. Traditional property and casualty products and certain life insurance company products rely on this exemption. However, many life insurers issue policies with investment components, such as annuities. A key feature in determining whether the products are exempt under Section 3(a)(8) of the 1933 Act is whether the insurer bears the investment risk of the product. If so, then the product may be viewed as insurance and is exempt from registration. If not, as is the case for variable annuities or market-value adjusted annuities, then the product is subject to federal securities regulation.

Indexed Annuities and Rule 151A

Traditional fixed annuities under Section 3(a)(8) have traditionally been treated in the same manner as insurance contracts and, therefore, have not been subject to registration under the 1933 Act. The primary characteristic leading to this determination is that traditional fixed annuities typically allocate the investment risk of the product to the insurance company. One type of annuity that has been the subject of discussion is the indexed annuity. Since insurance companies began offering these products, most issuing insurers have determined that indexed annuities fall within the exemption provided by Section 3(a)(8) of the 1933 Act and, therefore, are not securities subject to registration.

In January 2009, in an effort to address the applicability of Section 3(a)(8) of the 1933 Act to indexed annuities, the SEC adopted Rule 151A under the 1933 Act. Under Rule 151A, indexed annuities did not qualify for exemption provided by Section 3(a)(8) if (a) amounts payable by the issuer under the contract were calculated at or after the end of one or more specified crediting periods, in whole or in part, by reference to the performance during the crediting period or periods of a security, including a group or index of securities, and (b) the amounts payable by the insurer under the contract were “more likely than not” to exceed the amounts guaranteed under the contract.

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Rule 151A was scheduled to become effective on January 12, 2011, but on July 12, 2010, the D.C. Circuit vacated Rule 151A in a challenge brought by many insurance companies.[461] Section 2(b) of the 1933 Act requires that the SEC, when engaged in rulemaking, must consider whether a potential rule will promote efficiency, competition and capital formation. The D.C. Circuit found the SEC's determination that Rule 151A would promote efficiency, competition and capital formation to be arbitrary and capricious. The D.C. Circuit's ruling required the SEC to conduct further research on the impact of Rule 151A before reissuing Rule 151A. Shortly after Rule 151A was vacated by the D.C. Circuit, President Barack Obama signed Dodd-Frank into law, which included the Harkin Amendment, a group of provisions that regulate indexed annuities. The Harkin Amendment exempts indexed annuities from registration if three criteria are met. An indexed annuity is exempt from registration if it (i) has a value that does not vary according to the performance of a separate account, (ii) satisfies nonforfeiture requirements under state law or certain model laws, and (iii) is subject to regulation in a state that meets or exceeds the requirements of certain model laws. Many indexed annuities meet these requirements and are therefore exempt from registration under the 1933 Act. Following these developments, the SEC stated it would no longer pursue regulation of indexed annuities under Rule 151A. Indexed annuities will continue to be regulated under state law for the indefinite future.

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[461] Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2010).

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SECTION VI. OTHER MATTERS

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CHAPTER 15

REPURCHASING, EXCHANGING AND AMENDING AN ISSUER'S OUTSTANDING SECURITIES

GENERAL 346
PRIMARY SEC RULES AND REGULATIONS GOVERNING EQUITY SELF TENDER OFFERS 349
PRIMARY SEC RULES AND REGULATIONS GOVERNING DEBT SELF TENDER OFFERS 354
EXCHANGE OFFERS 357
CONSENT SOLICITATIONS 358

GENERAL

Issuers may repurchase, exchange or alter the terms of outstanding securities to, among other things, change their capital structure, reduce the amount of outstanding equity, eliminate high coupon debt securities, reduce the amount of their outstanding debt or eliminate burdensome indenture covenants.

These transactions may offset the dilutive effects of acquisitions or stock option, dividend reinvestment, stock purchase or similar plans, increase earnings per share, return capital to shareholders or eliminate smaller holdings and thus reduce servicing costs. Public companies may also seek to purchase a sufficient amount of stock in order to "go private" because they have concluded that the cost associated with being a public company (*e.g.*, those costs associated with compliance with Sarbanes-Oxley and Dodd-Frank) outweigh the benefits.

An issuer can accomplish the foregoing by means of open market purchases, privately negotiated transactions, tender offers, exchange offers and consent solicitations. The method utilized by the issuer will be influenced by a variety of factors, including the terms of the securities,[462] the time period available to the issuer to accomplish its goal and the funds available to the issuer.

If the debt contains a call provision, permitting the issuer to redeem the outstanding debt, this may be the easiest and most effective means to employ. The redemption provisions of most indentures set forth specific procedures that must be strictly followed. Failure to fully comply with these procedures may prevent the issuer from redeeming its debt in accordance with its plans. Normally, a call provision will also include a formula for determining the redemption price. Generally, the initial redemption price will be at a

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[462] Some securities contain call provisions or require supermajority approval to adopt certain amendments to the instruments pursuant to which they were issued.

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premium to the face amount of the debt with the premium decreasing and eventually disappearing during the term of the debt.

Rule 10b-5 Considerations

Rule 10b-5 under the 1934 Act[463] generally prohibits the use of materially misleading statements or omissions in connection with the purchase or sale of a security. In each instance where an issuer purchases its securities, it must be sure that it does not purchase securities at a time when it is in possession of material non-public information in violation of Rule 10b-5. Some issuers impose "blackout periods" on their purchase activity at times when such information might exist.

Purchases in the Open Market and Privately Negotiated Transactions

Open market purchases may be the most economical method available to an issuer to purchase its securities, especially when it is not seeking to purchase a large percentage of the outstanding securities. Purchases of securities from time to time in the open market have an advantage over a tender offer (discussed below) in that they may be engaged in opportunistically, do not require the issuer to pay a premium over the current market price and generally do not require compliance with the tender offer rules and regulations.[464] Accordingly, the costs associated with such purchases are generally *de minimis*.

Privately negotiated transactions may be the most effective method available to an issuer if the security that the issuer is seeking to purchase is in the hands of a limited number of holders. In that instance, the issuer can negotiate directly with the holders. However, unlike open market purchases, in privately negotiated transactions the issuer will likely pay a premium over the prevailing market price.

In the case of either purchases in the open market or privately negotiated transactions the purchase activity, however, must be structured in such a manner as not to be classified as a "tender offer." If the purchases are classified as a tender offer, then in addition to the premium usually associated with such activity, the issuer will be subject to additional requirements and additional transaction costs that may be material.

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[463] Rule 10b-5 is discussed in Chapter 16 (*Liabilities Under U.S. Securities Laws*).

[464] In addition to the rules and regulations discussed in this chapter below, the issuer should consider if the proposed purchases could be viewed as manipulative. The increased demand for an issuer's stock created by a stock purchase program may result in an increase in the market price, which is not problematic unless the purchases are made to manipulate the price of the stock. Rule 10b-18 under the 1934 Act provides all issuers with a safe harbor in which to conduct stock purchase programs without fear of being accused of manipulation. If the rule's conditions are met, Rule 10b-18 purchases will not be deemed to violate the anti-manipulation provisions of Section 9(a)(2) or Section 10(b) of the 1934 Act or Rule 10b-5 under the 1934 Act "solely by reason of the time, price or amount of the Rule 10b-18 purchases, or the number of brokers or dealers used in connection with such purchases."

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Tender Offers

While the 1934 Act does not contain a definition of what types of purchases constitute a "tender offer," it does set forth specific rules applicable to transactions that are tender offers.[465] The determination of whether a particular purchase program constitutes a tender offer is made by applying a series of subjective factors that have evolved from elements suggested by the SEC and court decisions. The SEC has suggested that courts look to the following eight factors in determining the existence of a tender offer:

- whether there is an active and widespread solicitation of securityholders;
- whether the solicitation is for a substantial percentage of the issuer's securities;
- whether the offer to purchase is made at a premium over the prevailing market price;
- whether the terms of the offer are firm rather than negotiable;
- whether the offer is contingent upon the tender of a fixed minimum number of securities or subject to a ceiling of a fixed maximum number of securities to be purchased;
- whether the offer is open for only a limited period of time;
- whether the offerees are pressured to respond and sell into the offer; and
- whether public announcements of a purchasing program precede or accompany a rapid accumulation of large amounts of the subject securities.[466]

Due to the absence of a statutory definition of a tender offer, numerous court decisions have considered whether open market and privately negotiated purchases constitute a tender offer, requiring the protections of the applicable rules under the 1934 Act.[467] As a result of these court decisions, it has become clear that large open market or privately negotiated transactions do not necessarily constitute tender offers solely as a result of the percentage of securities acquired or the number of persons from whom the acquisitions are made. What is less clear, however, is whether and how the eight factor test is to be applied in determining whether a particular purchase transaction or series of transactions, not constituting a conventional tender offer, should be treated as a tender offer. The SEC has not

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[465] Certain of these rules are discussed below in this chapter.

[466] The SEC's eight factor test was first set forth and adopted by a court in *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979), aff'd, 682 F.2d 355 (2d Cir. 1982), cert. denied, 460 U.S. 1069 (1983).

[467] See *Securities and Exchange Commission v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945 (9th Cir. 1985) and Hanson Trust PLC v. SCM Corporation, 774 F.2d 47 (2d Cir. 1985).

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provided any specific guidance on how the test should be applied. Accordingly, whether open market purchases or privately negotiated transactions constitute a "creeping" or *de facto* tender offer will be determined by the particular facts and circumstances.

If the purchase activity is classified as a tender offer, compliance with certain provisions of the federal securities laws, and the rules and regulations thereunder, is required.[468] If those provisions are not complied with, during a tender offer or an open market purchase program or privately negotiated transactions preceding or following a tender offer, the issuer may be subject to challenge by the SEC or securityholders alleging that:

- some aspect of the tender offer constitutes a fraudulent, deceptive or manipulative act as a result of noncompliance with applicable rules and regulations;
- an open market purchase program or privately negotiated transaction(s) prior to a tender offer constitutes a "creeping" tender offer in violation of the tender offer rules and regulations; or
- an open market purchase program or privately negotiated transaction(s) following a tender offer constitutes a *de facto* extension of the tender offer not in compliance with applicable rules and regulations.

PRIMARY SEC RULES AND REGULATIONS GOVERNING EQUITY SELF TENDER OFFERS[469]

A cash tender offer may be the most efficient way for an issuer to acquire a large block of its own securities in a relatively brief time. Tender offers, unlike open market purchases or privately negotiated transactions, are strictly regulated under the 1934 Act.

Regulatory Framework

Issuer tender offers for equity securities[470] are regulated by Section 13(e) and Rule 13e-4 under the 1934 Act. In addition, issuer equity tender offers, like all other tender

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[468] See Regulation 14E under the 1934 Act (applicable to all tender offers except those for "exempted securities"), Rule 13e-4 under the 1934 Act (for issuer equity tender offers) and Regulation 14D under the 1934 Act (for certain third-party equity tender offers).

[469] In addition to the rules and regulations discussed below, the issuer should consider if the proposed purchases could be viewed as manipulative. See note 464 above.

[470] Section 3(a)(11) of the 1934 Act defines an "equity security" as any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the SEC shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

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offers, are subject to the general anti-fraud and anti-manipulative provisions of Regulation 14E under the 1934 Act.[471]

Section 13(e)(1) of the 1934 Act makes it unlawful for an issuer that has any class of equity securities registered under Section 12 of the 1934 Act, or which is a closed-end investment company registered under the 1940 Act, to purchase any of its equity securities (not just those registered under Section 12) in contravention of the rules and regulations of the SEC.

Rule 13e-4 under the 1934 Act regulates tender offers for equity securities (which include securities that are convertible into equity securities) made by an issuer that (i) has a class of equity securities registered pursuant to Section 12 of the 1934 Act, (ii) is required to file periodic reports pursuant to Section 15(d) of the 1934 Act or (iii) is a closed-end investment company registered under the 1940 Act.[472] Rule 13e-4 applies to tender offers for any equity securities of the issuer (not just those registered under Section 12 of the 1934 Act) as long as the issuer making the tender offer fits within any of the three categories described in the previous sentence.

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[471] Regulation 14E consists of Rules 14e-1 (unlawful/tender offer practices), 14e-2 (position of subject company with respect to tender offer), 14e-3 (transactions in securities on the basis of material, non-public information in the context of tender offers), 14e-4 (prohibited transactions in connection with partial tender offers), 14e-5 (prohibiting purchases outside of a tender offer), 14e-6 (repurchase offers by certain closed-end registered investment companies), 14e-7 (unlawful tender offer practices in connection with roll-ups) and 14e-8 (prohibited conduct in connection with pre-commencement communications).

[472] The SEC, by the adoption of its "Cross-Border Tender Offer Rules" (see Rule 13e-4(h)(8), Rule 14d-1(c) and (d) and Rule 14e-5(b)(10) under the 1934 Act and Rule 802 under the 1933 Act), provided relief from certain of the disclosure and procedure requirements of the 1934 Act and 1933 Act. See also Chapter 18 (*Acquisitions of U.S. Entities*). These exemptions do not provide relief from the general anti-fraud and anti-manipulation provisions of the federal securities laws. These rules were amended nine years after they were originally adopted because the SEC recognized that the exemptions did not operate as well as hoped and did not address the practical difficulties of various timing and logistical issues faced when determining U.S. ownership. Eligibility is based principally on the level of U.S. interest in a transaction, measured by the percentage of securities of a foreign company held by U.S. investors. The objective of the exemptions as originally adopted and as amended is to encourage offerors and issuers in cross-border transactions to permit U.S. securityholders to participate in the same manner as other securityholders. These rules make available certain exemptions from the application of many of the provisions of the 1934 Act and from the registration requirements of the 1933 Act. These exemptions are available in those circumstances in which U.S. securityholders do not hold more than a certain percentage of the target company stock. The so-called "Tier I" exemption under the 1934 Act applies where U.S. securityholders hold 10% or less of the target stock. The so-called "Tier II" exemption under the 1934 Act applies where U.S. securityholders hold 40% or less of the target stock. The Tier I and Tier II exemptions are only available if the securities are issued by a "foreign private issuer" as defined in Rule 3b-4(c) under the 1934 Act and the U.S. ownership is limited as described above. The rules provide detailed provisions intended to make clear when and how U.S. ownership is determined. If available, the Tier I exemption exempts a bidder from substantially all U.S. tender offer regulation while the Tier II exemption provides more limited relief from the U.S. tender offer rules. Rule 802 under the 1933 Act provides certain relief from the registration requirement of the 1933 Act if criteria similar to the Tier I criteria discussed above are met.

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Timing

An issuer tender offer must remain open until the expiration of (i) at least twenty business days[473] from its commencement[474] (if it is a business day, the date of the commencement is included in the business day count regardless of the time commenced on that day) and (ii) at least ten business days from the date that a notice is first published, sent or given to shareholders of an increase or decrease in the percentage of the class of securities being sought or the consideration offered or the dealer's soliciting fees.[475] However, the second requirement does not apply to the acceptance for payment of an additional amount of securities not in excess of 2% of the class of securities that is the subject of the tender offer.[476]

Procedures

As soon as practicable on the date of commencement of the issuer tender offer, the issuer must: (i) file with the SEC a Schedule TO, including all exhibits thereto; and (ii) publish, send or give to shareholders a summary term sheet of the transaction (as discussed in this chapter below) and the information required by Schedule TO (except the exhibits) or a fair and adequate summary of such information[477] by means of: (A) a long-form publication, (B) promptly mailing or otherwise furnishing the offer to purchase to each shareholder whose name appears on the most recent shareholder list of the issuer, or (C) (I) short-form publication (tombstone) and (II) if the tender offer is not subject to the SEC's "going private rule," Rule 13e-3 under the 1934 Act, promptly mailing the offer to purchase and a letter of transmittal to each requesting shareholder.[478]

In addition to mailing or otherwise furnishing an offer to purchase to shareholders, the issuer must also (i) contact each participant on the most recent security position listing of any clearing agency within the possession or access of the issuer and inquire as to the approximate number of beneficial owners of the securities, (ii) furnish such participant with a sufficient number of copies of the offer to purchase and (iii) agree to reimburse such

[473] Rule 13e-4(a)(3) under the 1934 Act defines a business day as any day, other than Saturday, Sunday or a federal holiday, consisting of the time period from 12:01 a.m. through 12:00 midnight Eastern time.

[474] Rule 13e-4(a)(4) under the 1934 Act defines commencement as the date on which the "means to tender" (*i.e.*, a transmittal form or a statement regarding how the transmittal form may be obtained) is "first published, sent or given" to securityholders.

[475] See Rule 13e-4(f)(1) under the 1934 Act.

[476] *Id.*

[477] See Rule 13e-4(b) and Rule 13e-4(d)(1) under the 1934 Act.

[478] See Rule 13e-4(e)(1)(iii)(B) under the 1934 Act.

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participant promptly for the cost of forwarding the offer to purchase to the beneficial owners.[479]

The issuer must file with the SEC an amendment to the Schedule TO reporting promptly any material changes in the information previously filed, as well as a final amendment reporting promptly the final results of the tender offer.[480] If a material change occurs in the information previously published, sent or given to shareholders, the issuer must disseminate promptly disclosure of the change in a manner reasonably calculated to inform shareholders of such change.[481]

Any pre-commencement communication made in connection with or relating to the tender offer (such as the announcement by press release prior to commencement of the tender offer of an intention to commence the tender offer) must be filed on a Schedule TO on the date of first use.[482] The SEC has adopted a rule that, among other things, makes it a fraudulent, deceptive or manipulative practice for a person to publicly announce plans to make a tender offer that has not yet commenced if that person does not intend to commence such offer within a reasonable period of time and complete the offer.[483]

Withdrawal Rights

Securities tendered pursuant to an issuer tender offer may be withdrawn: (i) at any time during which the tender offer remains open, and (ii) if not yet accepted for payment, after the expiration of forty business days from the commencement of the tender offer (regardless of any extension).[484]

Proration

If the tender offer is made for less than all the outstanding equity securities of a class and if a greater number is tendered, then the securities shall be taken up and paid for as nearly as may be prorated disregarding fractions, according to the number of securities deposited by each depositor provided that the issuer may (i) accept all securities tendered by "odd-lot" holders (persons who own beneficially or of record less than 100 shares) who tender all their securities before prorating securities tendered by others and (ii) accept by lot securities tendered by shareholders who tender all securities held by them and who tender those securities conditionally (*i.e.*, when tendering, elect to have either all or none or at least

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[479] See Rule 13e-4(e)(1)(ii) under the 1934 Act.

[480] See Rule 13e-4(c) under the 1934 Act.

[481] See Rule 13e-4(e)(3) under the 1934 Act.

[482] See Rule 13e-4(c) under the 1934 Act.

[483] See Rule 14e-8 under the 1934 Act.

[484] See Rule 13e-4(f)(2) under the 1934 Act.

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a minimum amount or none accepted), if the issuer first accepts all securities tendered by shareholders who tender their securities unconditionally).[485] These "conditional tenders" are sometimes provided for because the numbers of shares to be purchased from a particular shareholder may affect the tax treatment of the purchase to the shareholder and the shareholder's decision whether to tender.

Prompt Payment

The issuer must pay the consideration offered or return the tendered securities promptly after termination or withdrawal of the tender offer.[486]

Purchases Outside the Tender Offer

From the time the issuer tender offer is first publicly announced until the expiration of at least ten business days after the date of termination of the issuer tender offer, the issuer may not purchase the security that is the subject of the issuer tender offer other than pursuant to the tender offer.[487] This restriction also applies to any security of the same class and series or any right to purchase any such securities,[488] and generally includes purchases by the dealer manager.

All Holders; Best Price

No issuer or affiliate shall make a tender offer unless: (i) the tender offer is open to any shareholder of the class of securities subject to the tender offer (other than shareholders in states where the issuer is prohibited from making the tender offer) and (ii) the consideration paid to any shareholder pursuant to the tender offer is the highest consideration paid to any other shareholder during the tender offer.[489] If the consideration offered is increased during the issuer tender offer, then all securities that are acquired pursuant to the issuer tender offer must be acquired at the highest consideration offered.[490]

Pricing of Equity Tender Offers

Fixed Price Tender Offer

The issuer sets a price per share fixed at the commencement of a tender offer.

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[485] See Rule 13e-4(f)(3) under the 1934 Act.

[486] See Rule 13e-4(f)(5) under the 1934 Act.

[487] See Rule 13e-4(f)(6) under the 1934 Act.

[488] *Id.*

[489] See Rule 13e-4(f)(8) under the 1934 Act.

[490] See Rule 13e-4(f)(4) under the 1934 Act.

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Modified "Dutch Auction" Tender Offer

A modified "Dutch auction" tender offer is a tender offer where the issuer specifies the number of shares that it will purchase ("x shares") or the total consideration that it will pay ("consideration cap") and invites shareholders to tender their shares within a specified range of prices. The price range must be reasonable, typically a range of 15% above the minimum price of the issuer's shares, and shareholders can usually tender shares at price increments within this price range. At the end of the tender offer, the issuer selects the lowest single purchase price ("Purchase Price") that allows it to repurchase x shares or pay the consideration cap and pays the Purchase Price to all shareholders whose shares are accepted. Only shareholders who tendered their shares at prices at or below the Purchase Price will have their shares accepted for purchase. To maximize participation, issuers often give shareholders the option of electing to tender at the price selected by the issuer in the tender offer. Shareholders who make this election ensure that their shares will be purchased in the tender offer, subject to proration.

PRIMARY SEC RULES AND REGULATIONS GOVERNING DEBT SELF TENDER OFFERS

Issuer debt tender offers must comply with Regulation 14E under the 1934 Act. Unlike the rules applicable to equity tender offers, these rules do not set out any filing or specific disclosure requirements. Many of the rules related to debt tender offers have developed as a result of no-action letters issued by the staff of the SEC.

As a general rule, issuers in debt tender offers prefer to minimize the tender offer period to limit exposure to interest rate fluctuations. Several requests for no-action have been granted by the staff of the SEC in connection with the twenty business day tender offer period (and ten business day extension of the tender offer period upon announcement of an increase or decrease in the consideration offered) required by Rule 14e-1 under the 1934 Act.[491] The staff of the SEC concurred with the position that issuer debt tender offers need only be held open for seven to ten calendar days.[492] The relief granted in these no-action letters applies to situations where an issuer conducts a tender offer that:

- offers to purchase for cash any and all non-convertible debt of a particular class or series;

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[491] See Salomon Brothers Inc., SEC No-Action Letter, 1986 WL 65340 (Mar. 12, 1986); Goldman, Sachs & Co., SEC No-Action Letter, 1986 WL 66561 (Mar. 26, 1986); and Merrill Lynch, Pierce, Fenner & Smith Incorporated, SEC No-Action Letter, 1986 WL 67037 (July 2, 1986). These letters were submitted after Rule 14e-1 under the 1934 Act was amended to apply to all issuer tender offers, not only those conducted in circumstances where an issuer was engaged in a defensive tender offer for its equity securities, as had previously been the case.

[492] It was argued in those letters that, historically, issuer debt tender offers had been held open for a period considerably shorter than the twenty business days required by Rule 14e-1(a) under the 1934 Act, generally a period of seven to ten calendar days depending on a number of factors.

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- is open to all record and beneficial holders of that class or series of debt;
- is conducted in a manner designed to afford all record and beneficial holders of that class or series of debt a reasonable opportunity to participate in the tender offer, including the dissemination of the offer on an expedited basis in situations where the tender offer is open for a period of less than ten calendar days; and
- is not made in anticipation of or in response to other tender offers for the issuer's securities.[493]

Debt Tender Offer Purchase Price Determination

Fixed Spread Tender Offers

In order to avoid the interest rate risk associated with issuer debt tender offers, issuers have sought ways to postpone fixing the purchase price.[494] In this regard, the staff of the SEC granted no-action relief with respect to issuer debt tender offers for non-convertible, investment grade debt securities at a price to be determined on each day during the tender offer period by reference to a stated fixed spread over the then-current yield on a specified benchmark U.S. Treasury security determined as of the day of tender or the preceding day (a "fixed spread offer"). More recently, the staff of the SEC has allowed for the fixing of the exact consideration on the last day of the tender offer.[495]

The SEC staff's no-action position is subject to the conditions that such offer:

- is an offer for cash for any and all non-convertible, investment grade debt of a particular class or series;
- is open to all record and beneficial holders of that class or series of debt;
- is based upon a benchmark U.S. Treasury security for which information is reported each day in a daily newspaper of national circulation;

[493] The SEC added an additional factor in a subsequent no-action letter when it said that, while not stated expressly therein, the no-action position contained in the 1986 No-Action Letter (Salomon Brothers Inc., SEC No-Action Letter, 1986 WL 65340 (Mar. 12, 1986)) is limited to issuer debt tender offers for "*investment grade debt securities only*." See Salomon Brothers Inc., SEC No-Action Letter, 1990 WL 286946 (Oct. 1, 1990). In discussions with the staff of the SEC, it has been made clear that as long as the target security is rated "investment grade" by one of the rating agencies the issuer can, assuming all other conditions are satisfied, rely on the no-action letters.

[494] The premium offered in debt tender offers, unlike equity tender offers, is normally modest.

[495] See Thermo Fisher Scientific Inc., SEC No-Action Letter, 2009 WL 3825272 (Nov. 13, 2009).

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- is conducted in a manner designed to afford all record and beneficial holders of that class or series of debt a reasonable opportunity to participate in the tender offer, and, in the case of an offer conducted in reliance on the 1986 no-action letter (providing for an abbreviated offer period, discussed above), dissemination of the tender offer is made on an expedited basis;

- provides that all tendering holders of that class or series of debt are paid promptly for their tendered securities after such securities are accepted for payment; and

- is not made in anticipation of or in response to other tender offers for the issuer's securities.[496]

Real-Time Fixed Spread Cash Tender Offers

The staff of the SEC extended the above position to permit issuers to conduct debt tender offers for non-convertible, investment grade securities using a fixed spread pricing methodology in which the nominal purchase price is calculated by reference to a stated fixed spread over the most current yield on a benchmark U.S. Treasury security determined at the time the securityholder tenders the debt security (a "real-time fixed spread offer") rather than by reference to the yield on a benchmark U.S. Treasury security as of the day of tender or the preceding day as in a fixed spread offer. Real-time fixed spread offers further reduce interest rate risk since the yield is not determined daily but on a continuous basis, thereby eliminating exposure to interest rate movements, which may be significant, during the course of a day.[497]

The SEC staff's no-action position is subject to the conditions that such offer:

- is an offer for cash for any and all non-convertible, investment grade debt of a particular class or series;

- is open to all record and beneficial holders of that class or series of debt;

- identifies the specific benchmark U.S. Treasury security to be used and specifies the fixed spread to be added to the yield on the benchmark U.S. Treasury security;

- states the nominal purchase price that would have been payable based on the applicable reference yield immediately preceding the commencement of the tender offer;

- indicates the daily newspaper of national circulation that will provide the closing yield of the benchmark U.S. Treasury security on each day of the tender offer;

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[496] See Salomon Brothers Inc., SEC No-Action Letter, 1990 WL 286946 (Oct. 1, 1990).

[497] See Merrill Lynch, Pierce, Fenner & Smith Incorporated, SEC No-Action Letter, 1993 WL 270676 (July 19, 1993).

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- indicates the reference source to be used during the tender offer to establish the current yield on the benchmark U.S. Treasury security;

- describes the methodology used to calculate the purchase price for the tendered securities;

- indicates that the current yield on the benchmark U.S. Treasury security and the resulting nominal purchase price of the debt securities is accessible on a real-time basis by either calling the dealer manager collect or through an "800" telephone number, if established for the tender offer;

- is conducted in a manner designed to afford all record and beneficial holders of that class or series of debt a reasonable opportunity to participate in the tender offer, and, in the case of an offer to be held open for less than ten calendar days, dissemination of the offer must be on an expedited basis, and in no event may an offer be open for less than seven calendar days;

- provides that all tendering holders of that class or series of debt will be paid promptly for their tendered securities after such securities are accepted for payment; and

- is not made in anticipation of or in response to other tender offers for the issuer's securities.

In addition to the above conditions, the staff of the SEC requires the dealer manager to:

- make and maintain records showing at least the following information:
    - the date and time of each tender;
    - the current yield on the benchmark U.S. Treasury security at the time of each tender; and
    - the purchase price of the tendered securities based on that yield; and

- send a confirmation of the transaction to tendering debt holders providing the specifics of the transaction (including, upon request, the time of tender) no later than the next business day after the tender.

EXCHANGE OFFERS

As an alternative to the "cash" offers discussed in this chapter above, an issuer may offer to exchange a new security for the currently outstanding security. In order to induce holders to participate in an exchange offer, the issuer will have to offer some incentive to the holder for giving up their old security for a new one with different terms. Issuers conducting

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exchange offers cannot rely on the no-action letters discussed above which allow for a shortened tender offer period. Accordingly, exchange offers must be kept open for a minimum of twenty business days. In exchange offers, as in cash tender offers for debt, issuers will sometimes offer an incentive (an early participation payment) if holders tender during the first ten business days of a twenty-business-day offer.

Unlike the cash transactions discussed above, the exchange offer involves the offering of a "new security," which, in the absence of an available exemption, requires that such offer be registered pursuant to the 1933 Act. Issuers conducting exchange offers have frequently relied on the exemption provided by Section 3(a)(9) of the 1933 Act. Section 3(a)(9) exempts from registration "any security exchanged by the issuer with its existing securityholders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." If the issuer employs a dealer manager and that dealer manager is paid a fee for soliciting exchanges, the issuer will not be able to claim the exemption from registration provided by Section 3(a)(9). The SEC has provided guidance in a series of no-action letters[498] regarding permissible activities by a dealer manager in connection with a Section 3(a)(9) exempt exchange offer. While these letters are far from exhaustive in their scope, they tend to provide guidance regarding those activities that the SEC views as acceptable and those it views as unacceptable. As a general matter, issuers have also relied upon the private placement exemption provided by Section 4(a)(2) of the 1933 Act when the old securities have been held by a small number of holders.[499]

CONSENT SOLICITATIONS

An issuer may seek to amend the terms of the indenture pursuant to which its debt securities were issued to, among other things, remove certain restrictive covenants. Most indentures provide a mechanism allowing for their amendment upon the consent of the holders of the outstanding securities. In the case of most indentures, such amendment can be made with the consent of a majority of the holders. Some indentures provide that certain amendments require the consent of an amount greater than a majority (*i.e.*, 66T of the outstanding holders). The issuer may pay a separate fee for the consents. Upon receipt of the consent required to adopt the proposed amendment, the issuer and the trustee for the indenture will execute a supplement to the indenture pursuant to which the proposed amendment will become effective.

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[498] See Dean Witter & Co., Inc., SEC No-Action Letter, 1974 WL 11253 (Dec. 23, 1974) and Dean Witter & Co., Inc., SEC No-Action Letter, 1975 WL 11253 (Feb. 24, 1975); The Carter Organization, SEC No-Action Letter, 1975 WL 11258 (Apr. 7, 1975); Mortgage Investors of Washington, SEC No-Action Letter, 1980 WL 14902 (Oct. 8, 1980); Seaman Furniture Company, Inc., SEC No-Action Letter, 1989 WL 246436 (Oct. 10, 1989); International Controls Corp., SEC No-Action Letter, 1990 WL 285830 (Aug. 6, 1990); and Exxon Mobil Corporation, SEC No-Action Letter, 2002 WL 1438789 (June 28, 2002).

[499] See Chapter 8 (1933 Act-Exempt Offerings and Securities).

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CHAPTER 16

LIABILITIES UNDER U.S. SECURITIES LAWS

GENERAL 359
1933 ACT REGISTRATION STATEMENT LIABILITY 360
1933 ACT REGISTRATION VIOLATIONS; PROSPECTUS LIABILITY 363
1934 ACT – MANIPULATIVE OR DECEPTIVE DEVICES 367
1934 ACT – INSIDER TRADING 369
CONTROLLING PERSON LIABILITY 370
CLASS ACTIONS 370
SEC ENFORCEMENT POWERS AND CRIMINAL SANCTIONS 370
SARBANES-OXLEY 371

GENERAL

Issuers accessing the U.S. capital markets may be subject to potential liabilities under the U.S. federal securities laws arising from the public or private issuance of securities in the United States, as well as from the ensuing reporting and other obligations imposed under the 1934 Act. The following discussion is intended to identify and briefly describe some of these liabilities. See also Chapter 7 (*Ongoing Reporting and Other Requirements*), which identifies additional potential liabilities in connection with an issuer's ongoing reporting and other requirements. These discussions do not purport to address all areas of potential liability under U.S. federal and state securities laws.[500]

The 1933 Act and the 1934 Act, and the respective rules and regulations thereunder, contain specific provisions creating potential liability for issuers and their directors and officers. The principal liability provisions of the 1933 Act and the 1934 Act are discussed below.[501] In addition, the SEC has considerable enforcement powers under the 1933 Act and the 1934 Act, and criminal sanctions may be applicable in some cases as well.

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[500] For example, each of the 50 states of the United States has its own common law with respect to fraud or negligence that might provide for liability in connection with offerings and sales of securities and, in nearly all cases, statutes that specifically provide private rights of action with respect to securities offerings.

[501] This discussion reflects certain provisions of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), the basic purpose of which is to reduce abusive securities litigation.

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1933 ACT REGISTRATION STATEMENT LIABILITY

General

Pursuant to Section 11 of the 1933 Act, any person who acquires a security registered under the 1933 Act may bring an action if any part of the registration statement (which includes the prospectus), when that part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading. A fact is "material" if there is a substantial likelihood that a reasonable investor would, under all the circumstances, consider it important in reaching an investment decision.

The effective date of a registration statement is highly significant for purposes of Section 11 of the 1933 Act. Liability under Section 11 applies only to information within the registration statement as of its effective date. Historically, the effective date meant only the date of the SEC's order of effectiveness under Section 8(a) or 8(c). In practice under the integrated disclosure system, where incorporated 1934 Act annual reports stand in the place of post-effective amendments updating the registration statement contents, the filing date of a report on Form 10-K also will be construed as an effective date.

The SEC, as part of Securities Offering Reform, defined "effective date" in Rule 430B under the 1933 Act to include not only the original effective date under Section 8(a) and the effective date of a post-effective amendment, but also the earlier of the date a prospectus deemed to be a part of the registration statement is first used or the date of the first sale in the offering to which that prospectus relates. Prospectuses of this type are generally the supplements used to supply the detailed information concerning the terms of the offering, the securities offered and the plan of distribution, whose omission from the original form of prospectus is authorized by Rule 430B. As a result of the adoption of Rule 430B, issuers may be liable for certain information for which they were not previously responsible under Section 11 and underwriters, who formerly only might have been liable for such information under Section 11, now are clearly exposed to liability for misstatements and omissions in 1934 Act reports filed after the statutory effective date. The action, however, does not extend to other prospective defendants. Officers and directors signing the registration statement and the auditors, with any other experts, are not affected by the additional deemed effective dates added to Rule 430B by Securities Offering Reform. Because of this exclusion, new auditors' consents will not be required at the time of the filing under Rule 424.

Scope of Liability

Liability may be imposed upon every person who signed the registration statement (including the issuer, its principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer, its board of directors or persons performing similar functions); the issuer's directors and persons about to become directors of the issuer; "experts" (such as accountants) who have, with their consent, been named in the registration statement as having prepared or certified part of the registration statement or a report or

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valuation used in connection with the registration statement, with respect to the statement that has been prepared or certified; and every underwriter. Such persons are jointly and severally liable.[502] Each person held liable may receive contribution from others held liable unless such person is guilty of fraudulent misrepresentation and the others were not.

Reliance on the registration statement need not be proved in a claim under Section 11 unless the purchaser acquired the security after the issuer had made generally available to its securityholders an earnings statement covering a period of at least one year beginning after the effective date of the registration statement. If proof of reliance is required, such reliance may be established without proof of the reading of the registration statement.[503]

The issuer's liability is absolute unless it can show that the plaintiff knew of the misstatement or omission at the time of the acquisition of the applicable security. Directors of the issuer and officers of the issuer who signed the registration statement, as well as underwriters, will not be liable if they can affirmatively establish a "due diligence" defense.

Due Diligence Defense

To establish a due diligence defense with respect to any part of the registration statement not purporting to be made on the authority of an expert ("non-expertised"), a director, an officer or an underwriter must show that "he had, after reasonable investigation, reasonable ground to believe and did believe, … that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading…."[504]

To establish a due diligence defense with respect to any part of the registration statement purporting to be made on the authority of an expert ("expertised"), a director, an officer or an underwriter must show that "he had no reasonable ground to believe and did not believe … that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert…."

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[502] Outside directors are jointly and severally liable only to the extent they "knowingly" violate the securities laws.

[503] One appellate court has also held that, while reliance need not be proven in the usual Section 11 case, a plaintiff who committed to purchase shares in a merger prior to the issuance of the registration statement was barred from suit because reliance on the registration statement would have been impossible. See *APA Excelsior III L.P. v. Premiere Techs., Inc.*, 476 F.3d 1261, 1267-77 (11th Cir. 2007).

[504] For a discussion of the due diligence defense in the context of modern securities offerings, see Committee on Federal Regulation of Securities, *Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws*, 48 BUS. LAW. 1185 (1993); *In re WorldCom Secs. Litig.*, 346 F.Supp. 2d 628, 660-85 (S.D.N.Y. 2004) (underwriter due diligence). See also, *Annual Review of Federal Securities Regulation*, 57 BUS. LAW. 885,943-945 (2002) and *In re Enron Corporation Securities Litigation*, 2005 U.S. Dist. LEXIS 39927 (S.D.Texas 2005).

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In determining what constitutes reasonable investigation or reasonable grounds for belief, the standard of reasonableness is that required of a prudent man in the management of his own property. The SEC, in Rule 176 under the 1933 Act, has identified the following factors affecting a determination of what constitutes reasonable investigation and reasonable grounds for belief under Section 11:

(1) the type of issuer;

(2) the type of security;

(3) the type of person;

(4) the office held when the person is an officer;

(5) the presence or absence of another relationship to the issuer when the person is a director or proposed director;

(6) reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the issuer and the filing);

(7) when the person is an underwriter, the type of underwriting arrangements, the role of the particular person as an underwriter and the availability of information with respect to the registration; and

(8) whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated.

Damages

Under Section 11, a plaintiff may seek to recover damages equal to the difference between the amount paid for the security (not in excess of the public offering price) and the value of the security at the time the suit is brought. Different measures of damage apply where the plaintiff has sold the security at a loss. The defendant may reduce the damages by proving that part or all of the depreciation in the value of the security arose from a cause other than the misstatement or omission complained of.

Limitation on Actions

A private action under Section 11 of the 1933 Act must be brought within one year after the discovery of the untrue statement or omission, or after the discovery should have been made by the exercise of reasonable diligence. However, in no event may a private action under Section 11 be brought more than three years after the security was *bona fide* offered to the public. While these limitation provisions may not apply when the SEC is

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asking a court for an injunction, the SEC may be subject to a five-year limitation period where it seeks a civil fine or penalty.

1933 ACT REGISTRATION VIOLATIONS; PROSPECTUS LIABILITY

Registration Violations

Pursuant to Section 12(a)(1) of the 1933 Act, liability attaches to any person who offers or sells a security in violation of the registration requirements of Section 5 of the 1933 Act. Section 12(a)(1) is essentially a strict liability statute that imposes liability without regard to the seller's awareness of the violation, upon a showing by the investor of the jurisdictional use of the U.S. mails or interstate commerce, the lack of the required registration, and the sale of a security by the defendant.

Prospectus Liability

General

Pursuant to Section 12(a)(2) of the 1933 Act, liability attaches to any person who offers or sells a security (other than certain exempted securities[505]) "by the use of any means or instruments of transportation or communications in U.S. interstate commerce or of the U.S. mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading … and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission."

Section 12(a)(2) is applicable to public offerings by issuers or controlling shareholders. Based upon court decisions, strong arguments can be made that it does not apply to private placements[506] or to transactions in the secondary markets.[507] Section 12(a)(2) may, however, apply to public offerings made pursuant to Regulation S.[508]

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[505] Exempted securities are discussed in Chapter 8 (*Exempt Offerings and Securities*).

[506] See *Gustafson v. Alloyd Co*., 513 U.S. 561 (1995); *Glamorgan Coal Corp. v. Ratner's Group, PLC*, 1995 U.S. Dist. LEXIS 9548 (S.D.N.Y. 1995); *In re JWP, Inc. Sec. Litig*., 928 F. Supp. 1239 (S.D.N.Y. 1996); *Yung v. Lee*, 432 F.3d 142 (2d Cir. 2005); and *Rogers v. Sterling Foster & Co*., 222 F.Supp.2d (S.D.N.Y. 2004).

[507] See *Saslaw v. Al Askari*, 1997 U.S. Dist. LEXIS 5621 (S.D.N.Y. 1997); and *Shanahan v. Vallat*, 2004 U.S. Dist. LEXIS 25523 (S.D.N.Y. 2004).

[508] See Sloane Overseas Fund v. Sapiens Intern. Corp. N.V., 941 F.Supp. 1369 (S.D.N.Y. 1996).

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Due Diligence Defense

In accordance with the terms of the statute, a "due diligence" defense is available in a suit brought under Section 12(a)(2). Factors that courts have viewed as relevant to making a determination of what constitutes "reasonable care" for purposes of Section 12(a)(2)'s due diligence defense include:

(1) the amount of planning and promotional participation, such as designing the deal and contacting and attempting to persuade potential purchasers;

(2) access to source data against which the truth or falsity of representations can be tested;

(3) relative skill in ferreting out the truth; and

(4) pecuniary interest in the transaction's completion.

As a practical matter, there is little difference between what constitutes "reasonable care" necessary to establish the due diligence defense under Section 12(a)(2) and "reasonable investigation" necessary to establish the due diligence defense under Section 11, even though in adopting Securities Offering Reform the SEC suggested reasonable care is an easier standard to satisfy.

Impact of Securities Offering Reform

SEC Commentary on Securities Offering Reform

The SEC's commentary in the Securities Offering Reform adopting release includes two interpretations of Section 12(a)(2) that may be helpful to defendants. One is that Section 12(a)(2) does not require every communication to include all information required by SEC rules or all material information. The second is an acknowledgement that the standards of investigation and due care necessary to establish an affirmative defense under Section 12(a)(2) are lower than those required by Section 11(b).

Rule 159 – Information "Conveyed" at Time of Sale

Of all the rules adopted by the SEC as part of Securities Offering Reform, Rule 159 under the 1933 Act has probably had the most significant impact on how most capital markets transactions, whether SEC-registered, Rule 144A or Regulation S, are processed. The adoption of this rule has resulted in the development of new procedures to ensure that investors have all material pricing and other information at the time they agree to purchase a security, with the final offering documents and pricing supplements now relegated to a secondary role in providing such information to investors.

Pursuant to Rule 159, the question of material misstatement or omission must be evaluated on the basis of information "conveyed" to purchasers up to the point of sale. "Sale," as construed by the SEC for purposes of Rule 159, is the point at which an investor

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becomes committed to purchase the securities offered, not at closing or when payment is made.

Rule 159 provides that, for purposes of Section 12(a)(2), only information known to the investor at the time of sale should be taken into account. Information later provided should not be considered, in the SEC's view. In practice, Rule 159 is taken to apply in both 1933 Act-registered offerings and offerings where either the issuer or the offering is exempt from 1933 Act registration, although its applicability in the latter cases is not free from doubt. Rule 159 does not apply to Section 11, which judges only the information included in the registration statement as of the effective date. However, the fact that Rule 430B expands the definition of "effective date" to include the earlier of the date on which a form of prospectus is first used and the time of the first contract of sale of securities to which the prospectus relates lessens the value of the distinction.

Rule 159 creates serious liability concerns for issuers of all kinds where material developments occur around the time of sale but have not yet been reflected in SEC filings or in the information otherwise conveyed to investors. The problems Rule 159 creates may be most acute for issuers of asset-backed securities and for structured corporate securities. In offerings of asset-backed securities, the exact composition of the portfolio of pooled assets may not be known until closing. As a result, Rule 159 may present difficult evaluations of the disclosures made before the portfolio was formed. Similarly, the terms of complex structured securities are frequently not finalized until shortly before closing.

Rule 159 does not define the term "conveyed." The commentary of the SEC and its senior staff suggests that an investor may have to have been made actually aware of a new disclosure before it would be deemed to have been adequately "conveyed." The SEC's commentary also suggests that, in some cases, delivery of a new disclosure included in filed documents might not suffice unless investors otherwise have been made aware of the filing.

Based on the anti-waiver provision provided by Section 14 of the 1933 Act, the SEC does not believe that its intent for Rule 159 might be avoided by drafting documents so that a final contract would not exist until the final prospectus had been filed. Conceding that Rule 159 may provide reason to invalidate enforceable contracts to purchase securities, the SEC noted in adopting Securities Offering Reform its view that renegotiation of such contracts may also involve anti-waiver issues unless purchasers are given "adequate disclosure" of their contractual rights and of the new disclosure in question and the "meaningful ability to elect" whether to terminate the old contact and to enter into a new contract.

Section 12(a)(2) Seller Liability

Liability under Section 12(a)(2) attaches to any person who "offers or sells" by means of a materially misleading prospectus or oral communication. Although privity of contract between plaintiff and defendant is not necessary, the courts have found that, to hold persons other than immediate sellers liable, the person in question must have been an active participant in creating the defective disclosure. In direct offerings and in best-efforts

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underwritings, the issuer is, of course, a seller within the meaning of Section 12(a)(2). Most courts that have considered the question have found that, in the case of a firm commitment underwriting, where sales are made by the underwriters who have taken title to the securities from the issuer, the issuer does not become a seller through its customary participation in the preparation and filing of the registration statement.

Claiming to believe that "there is unwarranted uncertainty" concerning the question, as part of Securities Offering Reform, the SEC adopted Rule 159A under the 1933 Act, which provides that an issuer is generally a seller of securities for purposes of Section 12(a)(2), without regard to the form of underwriting agreement. The purport of Rule 159A is to make the issuer a person selling "by means of" any of the following communications that include an actionable misstatement or omission:

- any preliminary prospectus or prospectus of the issuer required to be filed under Rule 424;
- any free writing prospectus prepared by or on behalf of the issuer or used or referred to by it;
- any part of any other free writing prospectus including material information about the issuer or its securities and furnished by or on behalf of the issuer; or
- any other communication constituting an offering made by the issuer to the plaintiff.

Damages

Under Section 12 of the 1933 Act, a plaintiff may seek to rescind his purchase of the security. Alternatively, the plaintiff may recover rescissionary damages if he or she no longer owns the security. However, a defendant may be able to avoid rescissionary damages if the defendant proves that the depreciation in the value of a security resulted from factors unrelated to the alleged misstatement or omission contained in the prospectus.

Limitation on Actions

An action under Section 12(a)(2) of the 1933 Act must be brought within one year after the discovery of the untrue statement or omission, or after discovery should have been made by the exercise of reasonable diligence, and within three years after the sale. An action under Section 12(a)(1) must be brought within one year after the violation on which it is based, and in no event shall any such action be brought more than three years after the security was *bona fide* offered to the public.

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1934 ACT – MANIPULATIVE OR DECEPTIVE DEVICES

Section 10(b) of the 1934 Act and Rule 10b-5 thereunder are the provisions most frequently invoked by persons seeking redress for alleged securities fraud. Rule 10b-5 provides as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Section 10(b) and Rule 10b-5 apply to manipulative or deceptive acts in either the purchase or sale of securities in both the initial distribution and the secondary market, whether arising from a registration statement, private negotiations, a corporate report, a proxy statement, a tender offer or otherwise. Investors have an implied private right of action under Rule 10b-5 that has been recognized consistently by the courts. There is no private civil cause of action for aiding and abetting a violation of Rule 10b-5.[509]

Mere negligence or innocent mistakes will not render a person liable under Rule 10b-5. The Supreme Court has ruled that *scienter*, *i.e.*, a mental state embracing intent to deceive, manipulate or defraud, is required for liability under Rule 10b-5. More specifically, the plaintiff must plead facts giving rise to a strong inference of the defendant's fraudulent intent.[510] However, it is not required that the defendant be aware that his acts were

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[509] The Supreme Court, in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008), reaffirmed that a private civil action under Section 10(b) of the 1934 Act may only be brought against a party that makes a public statement or otherwise commits some act that is relied upon by the plaintiff, and does not extend to parties that merely engage in transactions that are misrepresented in the issuer's financial statements.

[510] In *Tellabs v. Makor*, 127 S.Ct. 2499 (2007), the Supreme Court defined a "strong inference" for pleading purposes as an inference, based on all of the facts alleged, "*at least as likely* as any plausible opposing inference." The inference need not be irrefutable or the most plausible inference, but it must be more than merely a plausible inference.

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illegal. Knowledge of the underlying facts is sufficient. Recklessness[511] may also satisfy the *scienter* requirement.[512]

A plaintiff asserting a Rule 10b-5 claim based on a material misrepresentation or omission in connection with the purchase or sale of a security must ordinarily establish that he or she justifiably relied on the issuer's disclosure. When the purchase or sale takes place in the secondary market, the so-called "fraud on the market" theory may excuse the plaintiff from having to demonstrate actual reliance. Under this theory, there is a presumption that the plaintiff traded in reliance on the integrity of a price set by the market and that this price is affected by any material misrepresentation or omission (*e.g.*, in the issuer's 1934 Act reports).

An analysis of the various fraud actions brought under Rule 10b-5 is beyond the scope of this chapter. However, the impact of the anti-fraud provisions of Rule 10b-5 generally on ongoing disclosure and corporate communications by issuers in the U.S. markets is discussed in more detail in Chapter 7 (*Ongoing Reporting and Other Requirements*).[513]

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[511] Recklessness has been defined in this context to mean highly unreasonable conduct, involving not merely simple, or even inexcusable negligence, but "an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the defendant must have been aware of it." *Franke v. Midwestern Okla. Dev. Auth*., 428 F. Supp. 719, 725 (W.D. Okla. 1976).

[512] The prevailing view in the U.S. Courts of Appeals is that reckless misconduct is sufficient to establish *scienter*. See, *e.g.*, *Press v. Chemical Inv. Serv. Corp*., 166 F.3d 529 (2d Cir. 1999); *City of Philadelphia v. Fleming Cos*., 264 F.3d 1245 (10th Cir. 2001). *In re Silicon Graphics Inc. Sec. Litig*., 183 F.3d 970 (9th Cir. 1999), which held that mere recklessness is insufficient under the PSLRA and that "deliberate and conscious recklessness" is necessary to satisfy the *scienter* requirement, has been criticized and is not followed in most jurisdictions. The Supreme Court decision in *Tellabs v. Makor* refused to decide whether recklessness was sufficient, but may be understood to have cast doubt on the view that *scienter* requires "deliberate and conscious recklessness."

[513] Section 18 of the 1934 Act creates a cause of action on behalf of persons who can prove that they purchased or sold a security in reliance upon a "false or misleading" statement contained in a document filed with the SEC and that the statement affected the price of the security. Actions are rarely brought under this section due to the difficulty of proving that the purchase or sale was made in reliance upon the false or misleading statement and that such statement affected the price of the security. The 1934 Act also creates a limited cause of action in Section 9 for certain types of market manipulation. Section 14 of the 1934 Act has also been read by the courts to create private civil causes of action for false or misleading proxy statements (Section 14(a)) or "fraudulent, deceptive, or manipulative acts or practices" in connection with tender offers (Section 14(e)). The elements of the Section 14 causes of action—false or misleading statements or transactions, materiality, causation—are substantially similar to the Section 10(b) cause of action, but with a few significant differences, notably the fact that the Section 14(a) cause of action does not require proof of *scienter* and does not require the same showing of reliance. See, *e.g.*, *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991); *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970).

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Damages

A plaintiff under Rule 10b-5 may seek damages or rescission. Recovery for damages under the 1934 Act may include a disgorgement remedy, but is limited to an amount not in excess of actual damages on account of the act complained of, and the plaintiff must prove that the disclosure of the previously concealed facts, or the materialization of previously concealed risks, caused the loss in value of the plaintiff's investment.[514] Accordingly, punitive damages are not recoverable in a fraud action brought under Rule 10b-5. Such damages may be available, however, under state law. A defendant against whom a Rule 10b-5 claim is asserted has a right to contribution as a matter of federal law.

Limitation on Actions

Actions under Rule 10b-5 must be brought within two years after discovery of the facts constituting the violation and within five years after such violation.

1934 ACT – INSIDER TRADING

The 1934 Act expressly provides for liability for acts of insider trading and tipping. Under the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), insider traders and tippers may be subject to private actions as well as SEC civil actions and criminal proceedings.

The remedies provided under the ITSFEA are in addition to others that may be available under the U.S. federal securities laws, including Rule 10b-5.

The U.S. Supreme Court has held that a person who trades on material non-public information need not be an insider or receive the information from an insider to be liable under Rule 10b-5. It is enough that the person trading used the information in breach of a fiduciary duty owed to the source of the information.[515] However, a Rule 10b-5 claim may only be brought by the party to whom the duty was owed.

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[514] See Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 346 (2005).

[515] Rule 10b5-1 under the 1934 Act provides that insider trading liability arises when a person effects a transaction while "aware" of material non-public information and acted in breach of "a duty of trust or confidence" owed to the issuer, the shareholders of the issuer or the source of the non-public information. However, the rule provides certain affirmative defenses (*e.g.*, if the individual who traded while in possession of the material information can demonstrate that the transaction was part of a pre-existing contract or plan made in good faith).

Under Rule 10b5-2, a person receiving material non-public information owes a duty of trust or confidence, and thus could be liable under the misappropriation theory, in the following circumstances: (1) the person agreed to keep the information confidential; (2) the persons involved in the communication had a history, pattern, or practice of sharing confidences that resulted in a reasonable expectation of confidentiality; or (3) the person who provided the information was a spouse, parent, child or sibling of the recipient of the

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CONTROLLING PERSON LIABILITY

Section 15 of the 1933 Act provides that "controlling persons"[516] are jointly and severally liable with the controlled person who is liable under Section 11 or 12 of the 1933 Act. A controlling person may assert the affirmative defense that "the controlling person 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." Controlling persons may include persons who have the direct or indirect power to direct the management and policies of the issuer. Depending on the circumstances, the officers, directors or substantial shareholders of an issuer, for example, may be deemed to be controlling persons.

Section 20 of the 1934 Act sets forth a similar provision with respect to joint and several liability of controlling persons for violations by controlled persons of any provision of the 1934 Act or the rules and regulations thereunder.

CLASS ACTIONS

Private civil claims for violations of the federal securities laws may be brought under Rule 23 of the U.S. Federal Rules of Civil Procedure as "class actions." A class action is a suit brought by a representative of a group of persons with similar claims against a defendant. In order for an action to proceed as a class action, the court must be satisfied as to a number of factors, including that the class is too numerous to join each member as a plaintiff, that common questions of law or fact predominate over individual issues, and that the claims of the class representative are typical of those of the rest of the class. The PSLRA requires that the most appropriate plaintiff, usually the one with the greatest financial stake in the case, represent the class and select the lead counsel. The outcome of a class action generally is binding on all members of the class, unless they have affirmatively chosen to "opt out" of the class action.

Under the Securities Litigation Uniform Standards Act of 1998, the U.S. federal court is the exclusive venue for securities class actions, and securities claims based on state law may not be brought as class actions.

SEC ENFORCEMENT POWERS AND CRIMINAL SANCTIONS

In addition to the private actions discussed above in this chapter, an issuer that has violated the federal securities laws may face SEC civil actions and criminal sanctions.

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information, unless it were shown affirmatively, based on the facts and circumstances of the family relationship, that there was no reasonable expectation of confidentiality.

[516] The term "controlling person" means every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency or otherwise, controls another person.

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SEC Enforcement Powers

The SEC has a variety of enforcement and investigatory powers under the 1933 Act and the 1934 Act. In its discretion, the SEC may seek both judicial and administrative remedies.

The SEC may use the judicial process by going to court to seek injunctive relief against violators of the U.S. federal securities laws and other equitable relief, such as disgorgement of profits for violations of Section 10(b) and Rule 10b-5 under the 1934 Act. In addition, the SEC may seek civil fines in court. For example, with respect to insider trading violations, the SEC may seek a penalty of up to three times the profit gained or loss avoided by such insider trading. The SEC also may seek to bar or suspend any person from serving as an officer or director of an issuer that has securities registered under, or is required to file reports pursuant to, the 1934 Act.

Administrative remedies available to the SEC include the power to impose fines for violations of the U.S. federal securities laws. The SEC also has the power to enter cease-and-desist orders for any violation of the U.S. federal securities laws.

Criminal Sanctions

Persons who willfully violate the 1933 Act or the 1934 Act or the rules and regulations thereunder may be subject to criminal sanctions consisting of fines or imprisonment, or both. For example, natural persons who willfully violate the 1934 Act may be punished by a fine of up to $5 million ($25 million in the case of a person other than a natural person) or a prison term of up to twenty years, or both (though no person is subject to imprisonment for violation of a rule or regulation if he proves he had no knowledge of such rule or regulation).

SARBANES-OXLEY

Sarbanes-Oxley created new civil liabilities in the areas of audit committee standards and disclosure rules regarding financial experts, executive officer codes of ethics, off-balance sheet arrangements, and non-GAAP financial measures. Criminal penalties may apply in the areas of management disclosure certifications, document retention and whistleblower protections.[517]

[517] See Chapter 7 (*Ongoing Reporting and Other Requirements*).

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CHAPTER 17

DE-REGISTERING UNDER THE 1934 ACT

GENERAL 372
ENDING REPORTING OBLIGATIONS 373
HOLDERS OF RECORD 374

GENERAL

Under the 1934 Act, whether an issuer can terminate or suspend reporting obligations under Section 13(a) or 15(d) depends on how it became subject to the obligations. Once an issuer has terminated 1934 Act registration, it must also consider whether it has any residual reporting obligations under another section of the 1934 Act. As discussed in Chapter 7 (*Ongoing Reporting and Other Requirements*), a U.S. issuer may have become subject to 1934 Act reporting obligations by any one or more of the following:

- listing a class of equity or debt securities on U.S. securities exchange and registering the class under Section 12(b);
- for issuers other than banks and bank holding companies, registering a class of equity securities under Section 12(g) either voluntarily or because it had at fiscal year end more than $10 million in total assets and either 2,000 or more holders of record or 500 unaccredited investors as record holders;[518]
- for banks and bank holding companies, registering a class of equity securities under Section 12(g) of the 1934 Act either voluntarily or because it had more than $10 million in total assets and 2,000 or more securityholders of record;[519] or
- registering either equity or debt securities under a 1933 Act registration statement.

Section 12 registration subjects the issuer to reporting obligations under Section 13(a) of the 1934 Act, which persist at least until termination of 1934 Act registration. Issuers that register securities for public sale under the 1933 Act, but not under Section 12, become subject to identical reporting obligations under Section 15(d) for at least the remainder of the fiscal year in which the relevant 1933 Act registration statement becomes effective.

[518] Until the enactment of the JOBS Act, on April 5, 2012, the test was 500 record holders of any kind.

[519] Likewise an innovation of the JOBS Act. Until its enactment, the 500-record holder test applied.

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Among other things, the 1934 Act and the associated SEC rules establish an issuer's reporting requirements, which include obligations under Sarbanes-Oxley. Each registration under either act will result in reporting obligations for the issuer. These will relate to any class of securities that is the subject of 1933 Act or 1934 Act registration. Because this is so, an issuer may only terminate its 1934 Act reporting if it does so with respect to all of its outstanding classes of securities. In other words, an issuer will only be relieved of its obligations under the 1934 Act if it has no securities listed on a U.S. securities exchange, no securities registered under Section 12(g), and it is not required to file reports pursuant to Section 15(d).

ENDING REPORTING OBLIGATIONS

An issuer with securities listed on a U.S. exchange that wishes to end its obligations to file 1934 Act reports must first delist the securities and terminate the related registration under Section 12(b). Once this action is taken, it must consider whether the securities are deemed to be registered under Section 12(g) and whether any reporting obligations under Section 15(d), which are suspended if and so long the issuer has any securities registered under Section 12, have been brought back into force. Unlisted issuers terminating registration under Section 12(g) need only consider Section 15(d). Companies with no classes of securities registered under Section 12 need only consider Section 15(d) and the related rules.

In connection with delisting securities, the associated registration of the class under Section 12(b) should be terminated in accordance with the terms of Rule 12d2-2. In cases of voluntary delisting, the termination becomes effective ten days after the filing of a notification to the SEC on Form 25, as provided in paragraph (c) of the rule.[520]

After delisting and the termination of registration under Section 12(b), the delisted class may be deemed to be registered under Rule 12g-2. The purpose of the rule is to ensure that public information remains available for the issuer a class of securities that would have been required to be registered under Section 12(g) but for its listing on a U.S. exchange.[521] Rule 12g-2 does not apply to any class of securities that is not held of record by at least 300 persons at the time of delisting.

For issuers with a class of securities registered pursuant to Section 12(g), Rule 12g-4 permits termination of the registration upon certification to the SEC on Form 15 that the subject class is held of record by fewer than 300 persons or, if the issuer's total assets have

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[520] For reasons that are unclear, EDGAR recognizes a Form 15-12B even though nothing in the rules, the form or the staff's interpretations contemplates such a use. Form 15 by its terms is only associated with Sections 12(g) and 15(d) of the statute.

[521] Listed securities are exempt for the duration of the listing under Section 12(g)(2)(A).

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not exceeded $10 million on the last day of each of the issuer's most recent three fiscal years, by fewer than 500 persons.[522]

Reporting obligations under Section 15(d) of the 1934 Act, which ordinarily will be revived with the termination of registration under Section 12, may be immediately suspended pursuant to Rule 12h-3. The standards for suspension in reliance on 12h-3 are substantially uniform with those of Rule 12g-4, which is to say that the subject class is held of record by less than 300 persons or, if the issuer's total assets have not exceeded $10 million on the last day of each of the issuer's most recent three fiscal years, by less than 500 persons.[5]

Rule 12h-3(c) will not permit suspension unless the issuer has filed an annual report covering the fiscal year of the registered offering in question. The same provision makes suspension unavailable if the issuer has an effective 1933 Act registration statement that requires updating. However, the SEC staff will agree that, if the issuer removes all unsold securities from registration, the rule will be available.

The suspension of Section 15(d) reporting, whether under the statute or Rule 12h-3, is not necessarily permanent. The obligation will come back into force for any fiscal year if, on the first day of the fiscal year, the population of record holders is 300 or more persons.

Upon filing a Form 15, whether under Rule 12g-4, Rule 12h-3 or both, the issuer's obligation to file reports under the 1934 Act is immediately suspended. Unless the SEC objects, the issuer's 1934 Act registration and reporting obligations terminate ninety days after the issuer or its successor has filed the Form 15 with the SEC. If, however, the Form 15 is subsequently withdrawn or denied by the SEC, the issuer or its successor must, within sixty days after the date of withdrawal or denial, file with or submit to the SEC all reports that would have been required had the issuer not filed the Form 15.[523]

HOLDERS OF RECORD

Rule 12g5-1 under the 1934 Act defines "held of record" for all purposes under the 1934 Act. Securities are deemed held of record by each person who is identified on the records maintained by or on behalf of the issuer as the owner of the securities with the following qualifications:

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[522] As of the date of this publication, Rule 12g-4 and Form 15 have not yet been amended to reflect the new deregistration standard for banks and bank holding companies. Under the JOBS Act, banks and bank holding companies may terminate the registration under Section 12(g) of the 1934 Act by certifying to the SEC that the subject class of securities is held of record by fewer than 1,200 persons or, if the issuer's total assets have not exceeded $10 million on the last day of each of the issuer's most recent three fiscal years, by fewer than 2,000 holders of record. SEC staff no-action correspondence permit banks and bank holding companies to include an explanatory note on Form 15 indicating reliance on the JOBS Act amendments to Section 12(g)(4) of the 1934 Act to terminate registration and the related duty to file reports. See, *e.g.*, SEC no action letter to First Ottawa Bancshares, Inc., dated July 23, 2012.

[523] Rule 12h-3(a) under the 1934 Act.

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- in any case where records of securityholders have not been maintained in accordance with accepted practice, each additional person who would be identified as an owner on those records had the record been kept properly must be counted as a holder of record;

- securities identified as held of record by a corporation, a partnership, a trust whether or not the trustees are named or another organization shall be counted as held of record by one person;

- securities identified as held of record by one or more persons as trustees, executors, guardians, custodians or in other fiduciary capacities with respect to a single trust, estate or account shall be counted as held of record by one person;[524]

- securities held by two or more persons as co-owners shall be included as held by one person;

- each outstanding unregistered or bearer security shall be counted as held of record by a separate person, except to the extent that the issuer can establish that, if such securities were registered, they would be held of record, under the provisions of this rule by a lesser number of persons; and

- securities registered in substantially similar names where the issuer has reason to believe because of the address or other indications that such names represent the same person, may be included as held of record by one person;

subject to the following three provisions:

(1) securities held, to the knowledge of the issuer, subject to a voting trust, deposit agreement or similar arrangement as held of record by the record holders of the voting trust certificates, certificates of deposit, receipts or similar evidences of interest in such securities; *provided however*, that the issuer may rely in good faith on such information as is received in response to its request from a non-affiliated issuer of the certificates or evidences of interests;

(2) whole or fractional securities issued by a savings and loan association, building and loan association, cooperative bank, homestead association or similar institution for the sole purpose of qualifying a borrower for membership in the issuer, and which are to be redeemed or repurchased by the issuer when the

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[524] However, where securities are identified on the records maintained by or on behalf of the issuer as being owned by a person acting as custodian for individuals pursuant to separate accounts for each individual (such as through DTC), the securities are deemed "held of record" by each of such separate accounts. See, SEC letter to Techne Corporation, dated September 20, 1988.

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borrower's loan is terminated, shall not be included as held of record by any person; and

(3) if the issuer knows or has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of Section 12(g) or 15(d) of the 1934 Act, the beneficial owners of such securities shall be deemed to be the record owners thereof.

Furthermore, Section 12(g), as amended by the JOBS Act, allows exclusion from the enumeration of record holder persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of Section 5 of the 1933 Act.

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CHAPTER 18

ACQUISITIONS OF U.S. ENTITIES

INTRODUCTION 377
STRUCTURAL MATTERS 377
SELECTED RELATED MATTERS 379
TENDER OFFERS AND EXCHANGE OFFERS; COMMUNICATIONS UNDER THE 1933 ACT 381
PROXY SOLICITATIONS 383
CROSS-BORDER RULES 384
OVERVIEW OF OTHER SELECTED LEGAL ISSUES 385
CONCLUSION 391

INTRODUCTION

This chapter provides a brief overview of certain U.S. federal and state laws to be considered in connection with a possible acquisition of a U.S. company, a subsidiary or division of a U.S. company or any other U.S. legal entity, or the assets of any of the foregoing (a "U.S. target"). This chapter, particularly the discussion under "Cross-Border Rules," also addresses U.S. federal and state laws to be considered by acquirors of non-U.S. issuers with U.S. securityholders. This chapter does not review all the considerations related to acquiring a publicly-held company, such as the advisability of structuring such a transaction to avoid premature announcement of negotiations and to minimize the period between the announcement of a transaction and its consummation or other tactical and strategic operating or home country considerations that may be involved.

STRUCTURAL MATTERS

As a general matter, a non-U.S. acquiror is subject to the same rules and provisions as a U.S. company in effecting a U.S. merger and acquisition transaction. A non-U.S. acquiror, therefore, can benefit from the same techniques and methods that are available to domestic acquirors. As discussed below, however, non-U.S. acquirors may be subject to additional or different rules and requirements where certain regulated industries are involved.

There are three primary means of effecting merger and acquisition transactions involving a U.S. target: asset purchase, stock purchase and merger.

Asset Purchase

An acquiror can purchase all or substantially all the assets or only specified assets of a target, as may be agreed upon by the parties to the transaction. As part of such a transaction, the acquiror may assume specified liabilities of the target, again as may be agreed to by the parties, except in cases where the law specifically imposes successor

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liability on the purchaser. An asset purchase transaction can be utilized where the target is either a public company or a private company, or where the assets are housed in a division or operating unit of one of the foregoing. Having said that, transactions involving the purchase of substantially all the assets of a public company are relatively rare, because such transactions may expose the directors of the acquired company to personal liability in circumstances where the liabilities (including contingent liabilities) of the public company are not fully satisfied. Where divisions or operating units of public or private companies are involved, there are a number of additional considerations that may need to be taken into account in effecting such a transaction. However, these considerations are beyond the scope of this chapter.

Stock Purchase

An acquiror can also purchase the stock of the U.S. target by means of (i) an agreement with the target's shareholders (in the case of a privately held company or a subsidiary of a publicly- or privately-held company) or (ii) a tender offer (in the case of a target that is a publicly-held company) for all or part of the securities of the target. A tender offer can then be followed by a back-end merger (usually of a wholly-owned subsidiary of the acquiror into the target) in order to "squeeze out" any shareholders of the publicly-held target that did not participate in the tender offer. The tender offer aspects of such a transaction are discussed in greater detail below. Partnership and limited liability company interests can also be purchased in a similar manner.

In addition to those situations where an acquiror is seeking to acquire all of the outstanding stock of a U.S. target, the acquiror may also wish to acquire, for strategic investment or other reasons, less than all the stock of a target. In such situations, the acquiror may become subject to restrictions on insider trading, reporting requirements under Section 13 of the 1934 Act, and the applicability of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR Act"), which are discussed further below.

Merger

An acquiror can also structure the acquisition of a U.S. target as a one-step statutory merger between the target and either the acquiror directly or, more frequently, a subsidiary of the acquiror that acts as the acquisition vehicle. Generally, the shareholders of the target will need to approve such a transaction under the laws of the state in which the target is domiciled, usually at a special or annual meeting of shareholders. Where the target is a publicly-traded entity, the merger, as discussed above, can be combined with a tender offer as a means to obtain all the outstanding stock of the target.

Other Variations

While the foregoing are the basic types of transactions, there are variations that could be structured depending on the facts and circumstances of the particular transaction being contemplated. A description of such variations is beyond the scope of this chapter. As noted above, any of the foregoing transactions can be effected by the acquiror directly or through a

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subsidiary (wholly-owned or otherwise). The structuring of any transaction will depend upon a variety of strategic, operational, tax and accounting considerations that are beyond the scope of this chapter. Such considerations should, of course, be fully considered by the acquiror and its advisors prior to implementation.

In addition, while the acquisition by an acquiror of a U.S. target is most often effected through a negotiated transaction approved in advance by the target, an acquiror can propose the acquisition of a target without prior approval from the target of such a proposal. The making of any such "hostile" or "unsolicited" acquisition proposals or tender offers, or the commencement of any stock accumulation programs by an acquiror seeking a significant equity position in, or control of, a U.S. target, and a review of the mechanics and other issues involved is also beyond the scope of this chapter.

Forms of Payment

To effect any of the foregoing types of merger or acquisition transactions, an acquiror can use cash, stock of the acquiror, a combination thereof or some other form of consideration to pay for either the assets acquired or the stock purchased. Again, tax and accounting considerations, as well as timing considerations, need to be taken into account as part of such an assessment as to which form of consideration should be used.

If an acquiror issues its securities as consideration to purchase a U.S. target, the acquiror will be deemed to have offered its securities for sale and, absent an exemption, such securities would have to be registered on Form S-1, Form S-3 or, most often, Form S-4 (or, in the case of a foreign private issuer, Form F-1, Form F-3 or Form F-4) under the 1933 Act. Registration under the 1933 Act can be complex since a substantial amount of information must be disclosed about both the acquiror and the target.[525] The filing of such a registration statement will affect timing considerations. If the acquiror were purchasing a closely-held entity with securities, it could consider using the private placement exemption to avoid the registration process.[526] As referenced below under the description of the SEC's Cross-Border Rules, securities of a non-U.S. acquiror issued in a merger and acquisition transaction may be exempt from registration when U.S. investors hold small percentages of the non-U.S. acquiror's equity securities.

SELECTED RELATED MATTERS

Acquirors should also bear in mind the following when contemplating U.S. mergers and acquisitions.

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[525] See Chapter 3 (*The Securities Registration and Reporting Process*).

[526] See Chapter 8 (*Exempt Offerings and Securities*).

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Antitrust Issues

Regardless of whether there are any antitrust obstacles to effecting a proposed transaction, acquirors usually need to report an acquisition exceeding certain size thresholds in advance to the U.S. antitrust agencies as discussed in greater detail below.

Insider Trading and Disclosure of Information

Acquirors should be aware that insider trading issues may be involved whenever the other party is a public company (including the seller of assets or the parent of a division that may be acquired in a stock or asset transaction). An acquiror may also be precluded from purchasing shares of the U.S. target if the acquiror is in possession of material non-public information about the target.[527]

Schedules 13D and 13G

If any acquiror directly or indirectly acquires beneficial ownership in excess of 5% of a publicly-traded class of equity securities of a U.S. target, the acquiror will be required to file a Schedule 13D[528] within ten calendar days of such event,[529] or, in certain cases, a short-form statement under Schedule 13G within forty-five days of such event. The SEC broadly interprets "beneficial ownership" as arising whenever a person or entity possesses or shares, directly or indirectly, alone or with others, the power to vote, sell or determine the disposition of a security.[530]

Section 16

If any acquiror acquires more than 10% of any publicly-traded class of equity securities of the U.S. target, it will become an "insider" and accordingly will have an obligation to file within ten days a report with the SEC under Section 16(a) of the 1934 Act. Thereafter, subsequent trades must be reported within two business days. In addition, an insider may have to disgorge any short-swing profits resulting from purchases and sales made within any six-month period.[531]

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[527] Rule 10b-5 under the 1934 Act.

[528] Section 13(d)(1) of the 1934 Act, Rule 13d-1(a) under the 1934 Act.

[529] Rule 13d-1(c) under the 1934 Act. Acquirors generally may file a Schedule 13G instead of a Schedule 13D if (a) the acquiror does not beneficially own, directly or indirectly, more than 20% of the class; and (b) the acquiror has acquired the securities without the purpose or effect of changing or influencing the control of the issuer of the securities.

[530] Rule 13d-3(a) under the 1934 Act.

[531] Directors and officers also have obligations under Section 16(b) of the 1934 Act, as do control shareholders who own more than 10% of any class of stock.

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Sarbanes-Oxley

Acquirors also need to be mindful of the enhanced disclosure and financial reporting requirements under the U.S. securities laws as a result of the enactment of Sarbanes-Oxley if they seek to register securities as part of a proposed transaction or are otherwise required to file ongoing reports with the SEC. Many of the requirements contained in Sarbanes-Oxley apply to all public companies in the United States, including non-U.S. companies, such as those requiring certifications of financial reports, preparation and disclosure of internal control reports, rules governing the composition of boards and audit committees and prohibitions on extending, maintaining or arranging loans to directors and executive officers.[532]

TENDER OFFERS AND EXCHANGE OFFERS; COMMUNICATIONS UNDER THE 1933 ACT[533]

As noted above, in certain instances, a U.S. target can be acquired using a tender offer. A tender offer is an offer to buy shares of a publicly-held target (usually at a premium above the prevailing market price) for cash, securities or both, most often with the objective of taking control of the target company. An exchange offer is a tender offer in which the bidder offers securities (usually its own) in exchange for the securities of the U.S. target at a specified exchange ratio.

The rules governing tender offers and exchange offers for shares of U.S. companies are complex and a full review of these rules is beyond the scope of this chapter. In brief, however, under the current rules, when an acquiror decides to make a tender offer for the securities of a U.S. target, it first must publicly announce its intention to make the offer. The SEC's rules prohibit bidders and their representatives from announcing an offer with the intent to manipulate the market price of the stock of the bidder or the target without the intent to commence the offer within a reasonable time or without a reasonable belief that the bidder has the means to purchase the securities sought. The public announcement of information regarding a tender offer must be filed with the SEC on the date of first use and must contain a legend advising securityholders to read the full tender offer statement when it becomes available.

An obligation to file certain disclosure documents is triggered at the time of the "commencement" of a tender offer. Under the SEC's 1999 Release regarding mergers and acquisitions ("Regulation M-A"),[534] the obligation to file the required disclosure document with the SEC commences upon providing the target's securityholders with the "means to tender" their securities, which may include, for example, transmittal forms or instructions on

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[532] See Chapter 7 (*Ongoing Reporting and Other Requirements*).

[533] See also Chapter 15 (*Repurchasing, Exchanging and Amending an Issuer's Outstanding Securities*).

[534] SEC Release No. 33-7760 (Oct. 26, 1999) (http://www.sec.gov/rules/final/33-7760.htm).

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how to tender shares. The tender offer must remain open for at least twenty business days (during which time securities may not be purchased by the bidder, either in the tender offer or otherwise, and shareholders may withdraw tendered shares). The tender offer rules provide for a subsequent offering period, if so desired, without withdrawal rights. Changes to the terms of the tender offer may require extension of the twenty-business-day period.

Exchange offers, on the other hand, commence when the registration statement covering the securities of the bidder to be exchanged for the securities of the U.S. target is first filed with the SEC, assuming the bidder satisfies certain specified requirements. If the bidder does not satisfy the specified requirements by the time the registration statement is filed with the SEC, the exchange offer will commence when the bidder satisfies the specified requirements, up to the date of effectiveness. Any securities tendered in the offer cannot be purchased until after the registration statement covering the exchange offer becomes effective, the minimum 20-business-day tender offer period has expired and all material changes to the registration statement are disseminated to securityholders of the U.S. target with adequate time remaining in the offer for securityholders to review and act upon the information. If material changes require the dissemination of a supplement to the registration statement, the SEC rules require that the offer must remain open for at least five business days from the date of such changes if the material changes do not relate to the offer price or the amount of securities being sought and ten business days from such date if the material changes relate to price, the number of shares sought, the dealer's soliciting fee or changes of similar significance. If fewer days remain in the offer than the material changes would require, then the expiration date would have to be extended for the appropriate period of time. The shareholders of the target company have the right to withdraw their tendered securities at any time before they are purchased by the bidder.

Required Disclosure

Any party commencing a tender offer is required to file a Schedule TO with the SEC and deliver the Schedule TO to the U.S. target on the day the tender offer commences. The information that the filing party is required to disclose is described in the 1934 Act's tender offer rules and Schedule TO. This includes, among other things, information about its directors and officers, including any controlling person and its directors and officers, any criminal convictions or certain civil injunctions against such persons in the past five years, the purpose of the transaction, and the source and amount of funds for the purchase of shares. The acquiror has the obligation not to misstate any material fact or to omit to state any material fact necessary in order to make its statements in the Schedule TO not misleading. This means that an acquiror may have to disclose material non-public information about itself. Thus, prior to commencing a tender offer, an acquiror should consider whether there are any matters concerning its directors and officers and its business that it would prefer not to disclose. In addition, an acquiror may need to disclose certain financial information about itself and, in the case of a non-U.S. acquiror, may need to reconcile its financial information to U.S. GAAP. In a cash merger, financial statements and other information about an acquiror must be provided only if they are material to a voting securityholder's evaluation of the transaction. The SEC also requires financial statements covering the acquiror's past two

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fiscal years where the acquiror's financial statements will be material to a securityholder's voting decision.

Communications under the Tender Offer Rules

Under Regulation M-A, a bidder is permitted to communicate with securityholders and the marketplace about an upcoming tender offer or business combination (orally or in writing) prior to the filing and effectiveness of a registration or tender offer statement. There are no content restrictions on such communications other than the anti-fraud provisions of the 1934 Act and regulations thereunder, as well as state securities laws. All written communications in connection with a business combination transaction, however, must be filed on or before the date of first use. The goal of the rules is to end selective disclosure of information to analysts but not to the public at large, although it is acknowledged that such selective disclosure may continue on a limited basis, since oral communications are not required to be filed.

Again, the rules related to communications in connection with tender offers are complex, and the foregoing only touches on certain aspects of these rules. A party seeking to fully understand such rules should consult its advisors.

PROXY SOLICITATIONS

Proxy solicitations are requests by one party (generally, institutional investors or potential acquirors) for authority to act for another (usually to vote shares). Solicitations of proxies are sometimes used in a variety of corporate transactions, including acquisitions. Certain transactions, such as the merger of a publicly-traded company, or the sale of substantially all the assets of a public company, generally require approval by the shareholders of the target company. The solicitation of approval of these transactions is governed by Section 14 of the 1934 Act. Section 14 prohibits any person from soliciting a proxy in violation of the SEC's proxy rules. These rules apply to every proxy solicitation of the shareholders of a U.S. target, with few exceptions. The proxy rules expressly prohibit certain solicitations, including those containing any false or misleading statements. Each proxy must clearly and impartially identify each matter or related group of matters to be acted on. It must also provide a means to allow the person solicited an opportunity to specify a choice among approval, disapproval and abstention regarding each matter. Copies of the preliminary proxy statement usually must be filed with the SEC at least ten calendar days before definitive copies are first published or delivered to shareholders. There are numerous other rules relating to proxies that either must be complied with or to which parties may avail themselves that are not reviewed here.

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CROSS-BORDER RULES

In addition to issuing Regulation M-A, the SEC has also adopted rules for cross-border tender and exchange offers, business combinations and rights offerings ("Cross-Border Rules").[535] The primary purpose of the Cross-Border Rules is to encourage bidders for the securities of foreign private issuers with a limited number of U.S. securityholders to extend their offers to U.S. holders of those securities. The Cross-Border Rules are intended to balance this goal against the need to provide U.S. securityholders with the protections of the U.S. securities laws. In brief, the Cross-Border Rules provide exemptive relief from certain aspects of U.S. securities laws, as discussed in this chapter below and as more fully described in the Cross-Border Release.

Tier I Exemption

Tender offers for securities of non-U.S. issuers are exempt from most provisions of the U.S. tender offer rules so long as U.S. investors hold 10% or less of the securities subject to the offer. (Under the Cross-Border Release, this is known as the "Tier I" exemption.) The acquiror must submit Form CB to the SEC for the purpose of providing U.S. securityholders and the SEC with an English translation of any informational materials sent by it to non-U.S. stockholders. Non-U.S. acquirors must also file with the SEC a consent to service of process in the United States on Form F-X. Both of these Forms must be filed electronically. The most important requirement under the Tier I exemption is "equal treatment," which requires, subject to certain exceptions, that U.S. stockholders be permitted to participate in the offer on terms at least as favorable as those for non-U.S. stockholders. A non-U.S. acquiror must also comply with the applicable regulations of its home jurisdiction in order to be entitled to the Tier I relief.

Tier II Exemption

Tender offers for securities of non-U.S. issuers are also granted limited exemptive relief from certain U.S. tender offer rules if U.S. investors hold more than 10% but not more than 40% of the securities subject to the offer. (Under the Cross-Border Release, this is known as the "Tier II" exemption.) For example, acquirors meeting the exemption requirements may reduce or waive the minimum tender condition requirement without extending withdrawal rights during the remainder of the offer if certain conditions are satisfied. This exemption avoids the need for an SEC exemptive order or a no-action letter in certain situations where U.S. tender offer rules conflict with rules of other jurisdictions. The Tier II exemption largely represents a codification of relief previously granted to acquirors on a case-by-case basis. The exemption is a limited exemption, which means that the remaining U.S. tender offer rules (related to procedural, disclosure and filing aspects) must be complied with. For example, non-U.S. acquirors must file a Schedule TO disclosure

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[535] SEC Release No. 33-7759 (Oct. 22, 1999) (http://www.sec.gov/rules/final/33-7759.htm) (the "Cross-Border Release").

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form. Like the Tier I exemption, separate offers may be made to U.S. stockholders and non-U.S. stockholders, so long as the offers are on similarly favorable terms. Unlike the Tier I exemption, the Tier II exemption does not permit a bidder to offer cash to U.S. securityholders while offering securities to non-U.S. securityholders. Other exceptions are considered on a case-by-case basis.

Exemptions from Rule 14e-5

Under Rule 14e-5 under the 1934 Act, persons making a tender or exchange offer for a security are prohibited from purchasing the securities that are the subject of such an offer, other than pursuant to the terms of the offer. Most foreign jurisdictions have no such prohibition. Tier I transactions are exempt from Rule 14e-5, provided that (i) the offering documents prominently disclose the possibility of purchases not pursuant to the terms of the offer and the manner in which the information about such purchases will be disclosed and (ii) the acquiror discloses information about such purchases in a manner comparable to that in its home jurisdiction. Tier II transactions are not *per se* exempt from Rule 14e-5, but the SEC will review requests for exemptions of these transactions on a case-by-case basis. The Cross-Border Rules also codify a limited class exemption for U.K. market makers and principal traders from Rule 14e-5 during certain Tier I or Tier II transactions.

OVERVIEW OF OTHER SELECTED LEGAL ISSUES

The acquisition of a U.S. target involves many areas of U.S. law in addition to the U.S. securities laws, such as antitrust law, federal and state regulatory law, tax law and state corporate law. The following is only a brief overview of some of these areas.

Hart-Scott-Rodino Antitrust Improvements Act of 1976 (“HSR Act”)

An acquiror effecting any of the foregoing types of transactions may have to report the acquisition to the Federal Trade Commission and the Department of Justice (“Antitrust Agencies”) and wait a prescribed period before consummating the transaction under the HSR Act.[536] The HSR Act reporting requirement is triggered once certain statutory size-of-the-parties and size-of-the-transaction thresholds are met. The initial waiting period (fifteen days in the case of an all cash tender offer and thirty days for all other reportable transactions) may be extended by the Antitrust Agencies in the event that they decide to investigate possible anticompetitive effects of the proposed transaction. Rules promulgated by the Antitrust Agencies contain a specific exemption for certain acquisitions by a non-U.S.

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[536] The HSR Notification and Report Form is not part of the public record and is specifically exempt from disclosure in response to a request made under the Freedom of Information Act. The most significant items on the Form are Item 4(c), which requires an acquiror to submit all studies or analyses that were prepared by or for any officer or director that were used for the purpose of evaluating the acquisition with respect to its competitive effects, and Item 4(d), which requires filing of confidential offering memoranda, reports of third parties analyzing competiton, and reports analyzing synergies and efficiencies. The U.S. Federal Trade Commission has interpreted these provisions broadly.

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acquiror. The exemption, however, is fact specific and focuses on the value of the U.S. assets or securities being acquired.

The HSR Act generally will require the filing of prior notification before acquiror closes the acquisition of a U.S. target's assets or voting securities that are valued in excess of a threshold amount (U.S. $68.2 million as of January 2012, and adjusted yearly for inflation), except in the case of an acquisition of up to 10% of a U.S. target's voting securities "solely for the purpose of investment." The HSR waiting period commences for most transactions upon receipt by the Antitrust Agencies of complete notification forms from all parties to the transaction that are required to file a notification report. In the case of a tender offer for a U.S. target (or an acquisition of voting securities from a third party), the waiting period commences on the date the acquiror files its notification report with the Antitrust Agencies. Although the target will be required to file a responsive report, its filing does not affect the waiting period. Because of the numerous technical exemptions from the HSR Act's reporting requirements, each acquisition should be reviewed independently to determine whether it is reportable under the HSR Act.

Other Federal and State Law Requirements Relevant to Non-U.S. Acquirors

Certain U.S. industries are governed by statutes and regulations that require approval from, or filing with, a federal or state governmental agency prior to a non-U.S. acquiror assuming control of a U.S. target. Delays associated with obtaining such approvals must also be considered as part of the overall evaluation process and may affect structuring considerations. Some of these industries include, but are not limited to, aviation, financial services, broadcasting and telecommunications, defense, energy and natural resources and shipping. Certain industries, including banking, insurance and land ownership, are also regulated at the state level.

In addition, a non-U.S. acquiror should note that acquisitions in certain industries may effectively be precluded by laws that regulate those industries. The following is a brief listing of certain statutory or regulatory provisions that may restrict the acquisition of a U.S. target by a non-U.S. acquiror or the activity of non-U.S. entities or U.S. businesses (incorporated in the United States) that are owned by non-U.S. citizens or entities:

- ***Agricultural Foreign Investment Disclosure Act.*** This Act requires a non-U.S. person or entity to file a report following the acquisition or transfer of an interest, other than a lien or security interest, in U.S. farming, ranching or forestry.

- ***Communications Satellite Act.*** This Act restricts non-U.S. ownership of wireless satellite networks.

- ***Edge Act.*** This Act places limits on non-U.S. ownership of corporations chartered by the Federal Reserve Board to participate in international banking and finance.

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- ***Federal Aviation Act.*** This Act prohibits non-U.S. airlines from operating domestic service in the United States and prevents non-U.S. airlines from owning more than 25% of the voting stock in a U.S. corporation serving the domestic market.

- ***Federal Communications Act.*** This Act prevents non-U.S. persons, entities or governments and U.S. entities controlled by non-U.S. interests from possessing a broadcast or common carrier license unless the Federal Communications Commission concludes that it will serve the "public interest" or unless certain conditions are met.

- ***Foreign Bank Supervision Enhancement Act.*** This Act establishes special clearance and oversight for non-U.S.-owned banks doing business in the United States.

- ***Foreign Investment in Real Property Tax Act.*** This Act requires reporting by non-U.S. entities holding direct investments in U.S. property interests having an aggregate value in excess of specified amounts.

- ***Immigration and Nationality Act.*** This Act provides that employees of non-U.S. companies who have obtained work visas in order to work in the United States for the purposes permitted by the Act may lose their legal status if U.S. investors obtain more than 50% of such company. Thus, a non-U.S. company should be aware of the immigration status of its employees and identify critical immigration consequences prior to permitting a U.S. investor to acquire a majority stake in its company.

- ***International Investment and Trade in Services Survey Act.*** This Act requires U.S. business entities to report acquisitions of a voting interest of 10% or more by non-U.S. persons. Along with the reporting requirements of non-U.S. investors, there are reporting requirements for U.S. citizens who assist in the acquisition or who enter into a joint venture with a non-U.S. person to create a U.S. business enterprise.

- ***Merchant Marine Act.*** This Act restricts the registration and licensing of vessels to those that are owned, chartered, or leased from the Secretary of Commerce by (i) a U.S. citizen, or (ii) a business entity that is organized in the United States and is controlled by U.S. citizens.

- ***Mineral Lands Leasing Act.*** This Act requires that an entity applying to the U.S. government for a federal lease to develop certain natural resources of the United States disclose the identity and citizenship of those owning more than 10% of the equity interest in such entity. The lease will be granted only on the condition that U.S. persons can obtain reciprocal licenses or leases from the home governments of non-U.S. shareholders.

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- ***Shelflands Act.*** This Act states that offshore leases for the development of energy resources may be held only by citizens, nationals and permanent resident aliens of the United States.

- ***Tax Equity and Fiscal Responsibility Act.*** This Act requires domestic and non-U.S. corporations that are controlled by a non-U.S. person and engage in a trade or business in the United States to file annual information reports.

- ***Exon-Florio Amendment.*** See the description below in this chapter.

Internal Revenue Code

The acquisition of a U.S. target may also present a number of complex tax issues under the Internal Revenue Code of 1986, as amended, that may determine the optimal structure of the transaction and may factor into the determination of how to finance the transaction. In the case of a non-U.S. acquiror acquiring a U.S. target, the purchaser's effective tax rate must also be analyzed along with any tax differences that may exist between the U.S. and the country of the non-U.S. acquiror's domicile and the effect of any tax treaties that may exist. The non-U.S. acquiror's home country tax rules may play a significant role in such a determination.[537]

Exon-Florio Amendment

Although not relevant to U.S. acquirors, the Exon-Florio Amendment to the Defense Production Act of 1950 ("Exon-Florio") gives the President of the United States, through his designee, the Committee on Foreign Investment in the United States ("CFIUS"), which is made up of a number of U.S. executive branch departments and agencies, the authority to suspend or prohibit the acquisition of a U.S. business by a non-U.S. acquiror if (i) there is credible evidence to believe that the non-U.S. acquiror might take action that threatens to impair the national security[538] and (ii) existing laws, other than the International Emergency Economic Powers Act and the Exon-Florio provision, do not provide adequate and appropriate authority to protect the national security.

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[537] See Chapter 15 (*Home Country Matters*) of *Accessing the U.S. Capital Markets – Non-U.S. Issuers* for a discussion of certain other of non-U.S. laws or regulations that affect nonresident securityholders. See Appendix A of *Accessing the U.S. Capital Markets – Securities Products* for a discussion of certain tax considerations for non-U.S. issuers.

[538] The term "national security" is undefined in the regulations. However, the U.S. Treasury Department has recently given guidance to the effect that CFIUS will continue to focus narrowly on genuine national security issues, and not on broader economic or other national interests. Among the key issues are the nature of the business being acquired, the identity of the foreign person acquiring control and the types of information required to access national security concerns. See http://www.treasury.gov/resource-center/international/foreign-investment/Documents/CFIUSGuidance.pdf.

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Under the Exon-Florio provision, parties to certain transactions, including a non-U.S. acquiror, may wish to file a report with CFIUS on the transaction for review. If CFIUS decides that the transaction may present national security concerns, it commences a forty-five day investigation to decide whether the issues require further mitigation efforts or a recommendation to the President for action. At the end of the forty-five-day period, the matter may be referred to the President who then has fifteen days to take final action. Since a typical transaction involving a non-U.S. acquiror and a U.S. target does not implicate the national security, many non-U.S. acquirors do not provide notice to CFIUS (notice, in any case, is voluntary). Consideration as to filing should be given, however, where the business of the U.S. target employs personnel with security clearance for classified governmental materials or enters into classified contracts with security-sensitive U.S. governmental agencies. In addition, under amendments to Exon-Florio that were passed in 2007, any transaction involving critical infrastructure, major energy assets and critical technologies is deemed to implicate the national security and acquirors of such assets should consider filing for review. Those amendments have also created a presumption that a forty-five-day investigation by CFIUS is required when (i) the acquiror is controlled by or acting on behalf of a foreign government, or (ii) the transaction could result in the control of any "critical infrastructure" by a foreign business, unless the Secretary of the Treasury and the head of the lead agency of the U.S. executive branch responsible for the review of the transaction jointly determine that the transaction will not impair the national security.

U.S. targets in hostile takeover situations may have some strategic alternatives available under Exon-Florio. In what is colloquially referred to as the "Pentagon Ploy," the U.S. target may choose to lobby the Department of Defense, or one of the other 11 agencies affiliated with CFIUS, to influence support for a formal investigation or to simply delay the acquisition. Even if foreign ownership restrictions do not apply, a non-U.S. acquiror must comply with the reporting requirements under the International Investment and Trade in Services Survey Act if it acquires 10% or more of a U.S. target's voting securities.

State Corporate Law; Other Impediments

In order to effect a merger or other form of acquisition, an acquiror must follow the procedures prescribed by the corporate laws of the state under which the target is organized. Such laws comprise the rules regarding shareholder and director approval of an acquisition transaction. In addition, state law frequently provides "appraisal rights" to dissenting shareholders that may entitle the shareholders to greater (or lesser) consideration than has been provided for in the merger agreement if certain steps are followed.

The target's organizational documents and state law requirements must be reviewed for any other rules or impediments that an acquiror should consider, including, but not limited to, any control share, business combination, or fair price anti-takeover statutes under the applicable state law. For example, Section 203 of the Delaware General Corporation Law generally prohibits a Delaware corporation from engaging in a "business combination" with any "interested stockholder" for a period of three years following the date that the stockholder became an interested stockholder, unless the transaction in which the person became an interested stockholder is approved in the manner required by such Section or the

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business combination is approved by a two-thirds vote of the shares held by persons unaffiliated with the interested stockholder. Generally, a "business combination" is defined to include mergers, asset sales and other transactions resulting in financial benefit to a stockholder, and an "interested stockholder" is a person who, together with affiliates and associates, owns, or within three years, did own, 15% or more of a corporation's voting stock.

The NYSE and NASDAQ also have rules governing certain share issuances that may need to be taken into account depending on the proposed structure of the transaction.[539] In addition, acquirors should be aware of possible takeover defenses that may be included in the charter or bylaws of a target or imposed by state law or adopted contractually.

A common takeover defense is the "poison pill," or shareholder rights plan, that acts to allow shareholders other than the hostile acquiror to purchase additional shares of the target company at a discounted price, thereby diluting the acquiror's security ownership position. Because the board of directors usually retains the right to redeem these plans, poison pill provisions can be used to force acquirors to negotiate with target companies. Some other anti-takeover defenses are:

- constituency statutes found under state law, which allow consideration of social, economic, and other factors relating to constituencies other than the shareholders (*e.g.*, the employees or residents of the state of incorporation) when evaluating a bid;

- staggered boards, which also prevent potential acquirors from electing their own board by requiring that only a portion of the total number of directors on the target's board be elected each year;

- fair price requirements;

- limitations on and methods for changing the size of the board;

- supermajority voting requirements for shareholders approving mergers, consolidations, and sales of assets; and

- cumulative voting, which allows shareholders to cast all their votes for one candidate for election to the board of directors, thereby limiting a potential acquiror's ability to elect the entire board of directors after acquiring a majority of the outstanding stock of a company.

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[539] See Chapter 6 (*Listing on U.S. Securities Exchanges*).

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CONCLUSION

There are many legal considerations that an acquiror needs to consider when contemplating an acquisition of a U.S. target. These issues must be identified and rapidly resolved in order to bring about a successful completion to any such acquisition. The foregoing briefly summarizes certain, but not all, of these considerations. It is not intended to be a step-by-step guide for an acquiror to effect the acquisition of a U.S. target, which should only be effected after a careful review with counsel of all relevant factors.

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CHAPTER 19

ACQUISITION FINANCE IN THE CAPITAL MARKETS

GENERAL 392
GENERAL FINANCIAL STATEMENT REQUIREMENTS 393
ADDITIONAL TARGET DISCLOSURE 397
PRIVATE PLACEMENTS VERSUS REGISTERED OFFERINGS 403
STRUCTURAL CONSIDERATIONS AND FORMAT OF THE SECURITIES OFFERING 404

GENERAL

Public companies acquiring another company, business unit or assets of another business may finance the purchase price for the acquisition with a securities offering or may while the acquisition is pending or on or shortly after its completion make a securities offering. The appropriate level of disclosure to be contained in a prospectus or other offering document about the acquisition and the target is an important consideration in any such securities offering. Depending on the size of the target relative to the size of the issuer, Regulation S-X sets forth for securities offerings registered under the 1933 Act specific requirements for historical financial statements of the target ("target historical financial statements") and for pro forma financial statements that give effect to the acquisition ("pro forma financial statements"). While the requirements for target historical financial statements and pro forma financial statements under Regulation S-X are formulaic in nature, the level of other disclosure concerning the acquisition and the target is generally dependent on the judgment of the issuer and other participants in the offering, including investment bankers and counsel.

Securities offerings for acquisition finance purposes also implicate issues that are unique to such financings, including tax- and shareholder consent-related matters. These financings may occur prior to the closing of the acquisition, when the acquiror has no need for the funds raised in the offering should the acquisition not be consummated or the target has not yet agreed to be acquired. These and other factors can impact the manner in which, and the structural features of, the securities that are offered.

The following discussion provides an overview of certain topics that participants in a securities offering may encounter in connection with an offering whose purpose is to fund an acquisition or is otherwise contemplated at or around the time of the consummation of an acquisition. These topics include:

- whether target historical financial statements and pro forma financial statements will be required, either pursuant to the requirements of Regulation S-X or as a matter of materiality as determined by the parties to the transaction and if so, the periods for which such financial statements are to be presented;

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- whether any further disclosure about the acquisition or the target is necessary to ensure the adequacy of the disclosure as a whole in the prospectus or other offering document relating to the offered securities; and

- certain rules and structural features of securities that are unique to these securities offerings.

GENERAL FINANCIAL STATEMENT REQUIREMENTS

Regulation S-X, under the circumstances set forth therein, requires the inclusion of target historical financial statements in the prospectus of an issuer engaging in a securities offering that is registered under the 1933 Act. In addition, the 1934 Act also requires an acquiror that is subject to the reporting requirements of the 1934 Act to file the target historical financial statements required by Regulation S-X on a Current Report on Form 8-K.

Whether pursuant to the 1933 Act or the 1934 Act, the requirements for, and the extent of, the historical periods required to be presented or filed, if any, are determined based on the significance of the acquisition to the acquiror. Set forth below is a brief summary of the provisions of Regulation S-X that apply in determining the significance of an acquisition and the historical periods to be presented in target historical financial statements.

The following discussion relates solely to the fulfillment of the technical requirements of Regulation S-X in relation to target historical financial statements and pro forma financial statements. While a prospectus may not be required to include target financial statements under Regulation S-X, the transaction parties nevertheless may determine to include target financial statements because they consider that information to be material to an investor's decision.

Regulation S-X Applies Only if the Acquisition is Probably or has Occurred

Section 3-05(a) of Regulation S-X specifies the general rule concerning the requirement and timing for target historical financial statements. Subject to the exceptions specified in Section 3-05, target historical financial statements will be required to be filed when the acquisition transaction has occurred or becomes probable.

The term "probable" is interpreted to mean "more likely than not." In general, and subject to the facts and circumstances surrounding the acquisition, the SEC takes the view that an acquisition becomes probable upon the signing of a letter of intent.[540]

[540] See Section 2005.4 of the of the Financial Reporting Manual published by the Division of Corporation Finance, which states that the "[a]ssessment of "probability" requires consideration of all available facts. [An] [a]cquisition is probable where [the] registrant's financial statements alone would not provide adequate financial information to make an investment decision." Accordingly, other factors, in addition to (continued)

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Determining the Level of Significance under Regulation S-X

Significance is determined by reference to the definition of "significant subsidiary" under Section 1-02 of Regulation S-X, substituting the 10% threshold set forth in the definition of that term with the thresholds discussed below.

For purposes of Regulation S-X, the level of significance is determined in accordance to the following three criteria:

- the percentage that the acquiror's investment in and advances to the target bears to the total consolidated assets of the acquiror;
- the percentage that the target's assets bears to the acquiror's total consolidated assets; and
- the percentage that the acquiror's equity in income from continuing operations[541] of the target bears to the acquiror's total consolidated income from operations.

The applicable level of significance of an acquisition is the highest level of the foregoing three significance criteria triggered by the acquisition. For example, if the business to be acquired meets two of the criteria of significance at the 19% level and one of the criteria at the 42% level, then the acquisition will be deemed to be an acquisition whose significance exceeds the 40% but does not exceed the 50% level of significance.

Target Historical Financial Statement Requirements

Set forth below is a brief summary of the requirements for, and the periods to be presented in, target historical financial statements, as set forth in Rule 3-05(b) of Regulation S-X:

Significance Criteria of Less than 20%

If the acquisition does not meet any of the significance criteria at the 20% level, then Rule 3-05(b) does not require target historical financial statements.

Significance Criteria that Exceeds 20% but not 40%

If any of the significance criteria exceeds 20% but none exceed 40%, then Rule 3-05(b) requires audited target historical financial statements for the immediately

whether a letter of intent has been executed, should be considered. See http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf.

[541] Before income taxes, extraordinary items and cumulative effect of a change in accounting principle.

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preceding fiscal year and unaudited interim target historical financial statements for any subsequent interim period.

Significance that Exceeds 40% but not 50%

If any of the significance criteria exceeds 40% but none exceed 50%, then Rule 3-05(b) requires audited target historical financial statements with two years of income statement data and balance sheet data as of the end of the immediately preceding fiscal year and unaudited interim target historical financial statements for any subsequent interim period.

Significance that Exceeds 50%

If any of the significance criteria exceeds 50%, Rule 3-05(b) requires full audited target historical financial statements (*i.e.*, three years of income statement data and balance sheet data as of the end of the two preceding fiscal years) and unaudited interim target historical financial statements for any subsequent interim period.

Pro Forma Financial Statement Requirements

Article 11 of Regulation S-X requires pro forma financial information in connection with any significant business combination.[542] In general, a business combination is significant if the business to be acquired meets or exceeds any of the significance criteria at the 20% level.

Article 11 requires pro forma financial statements giving effect to an acquisition to be presented for the most recently completed fiscal year of the acquiror and the target and any subsequent interim period.[543]

Time Frame in Which Acquisition Financial Statements Must be Provided

Prospectus - Significance that does not Exceed 50%

If the business to be acquired does not exceed any of the significance criteria at the 50% threshold, a registration statement may omit the target historical financial statements if:

- the acquisition has not yet been consummated or occurred; or

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[542] 11-02(a) of Regulation S-X specifies that "[p]ro forma financial information should provide investors with information about the continuing impact of a particular transaction by showing how it might have affected historical financial statements if the transaction had been consummated at an earlier time."

[543] Where the acquiror and the target have different fiscal year ends, if the fiscal year ends differ by more than ninety-three days, the target's fiscal year end will be required to be presented as though it ended on the same date as that of the acquiror.

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- the date of the final prospectus is no more than seventy-four days after the consummation of the acquisition.

Current Report on Form 8-K

Item 2.01 of Form 8-K requires the filing of a Current Report on Form 8-K by an acquiror in connection with the acquisition of a target or assets if:

- the net book value of the target, or the amount paid to acquire the assets, exceeds 10% of the total consolidated assets of the registrant; or

- the acquisition exceeds any of the significance criteria at the 20% level.

Such an 8-K, in accordance with the general instructions to Form 8-K, must be filed within four business days of the consummation of the acquisition.

Item 9.01 of Form 8-K requires the filing of the financial statements required by Rule 3-05(b)(2) of Regulation S-X within seventy-one calendar days of the date on which the issuer files the Current Report on Form 8-K pursuant to Item 2.01 of Form 8-K.[544]

Already Effective Shelf Registration Statements

If an acquisition that exceeds the 50% level on any of the significance criteria occurs or is probable, a registration statement will not be declared effective, and an already effective shelf registration statement should not be used for purposes of offering securities, until the required financial statements are filed with the SEC. If an acquisition exceeds the 20% level on any of the significance criteria but not the 50% level of any of the significance criteria, a registration statement will be declared effective, and an already effective shelf registration statement may be used for purposes of offering securities, during the "grace period" beginning after the date on which the acquisition is consummated and prior to the date that is seventy-five days after consummation of the transaction.[545]

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[544] If the financial statements are not available within this time frame, the issuer will be required to file this information when it becomes available.

[545] See Sections 2050.1 through 2050.7 ("2050") of the Financial Reporting Manual published by the Division of Corporation Finance. See http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml. It should be noted that while the instruction to Item 9.01 of Form 8-K specifies that the issuer will be deemed to be current for purposes of its filing requirements under the 1934 Act during the grace period, the instruction also specifies that registration statements will not be declared effective and already effective shelf registration statements should not be used for purposes of offering securities during the grace period. However, the provisions specified in 2050 of the Financial Reporting Manual are consistent with customary practice.

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ADDITIONAL TARGET DISCLOSURE

In addition to the requirements for financial statements set forth in Regulation S-X, where a material acquisition is pending or has recently occurred, additional disclosure about the acquisition and target may be necessary or advisable. The appropriate level of disclosure, taking into account the ease and ability of preparing the disclosure, as well as whether the absence of such additional disclosure could result in investors being ultimately disappointed with their investment, needs to be considered.

Transactional Disclosure

At a minimum, the offering document relating to an offering is likely to include a brief description of the acquisition. Investment bankers may want that disclosure for marketing purposes and, if the acquisition is material, it would normally be appropriate to inform investors of its occurrence. This discussion may be included in a "Recent Developments" section or subsection of the prospectus or other offering document. The discussion may include a brief description of the structure of the acquisition (including any contingencies or financing requirements), the target or business being acquired and the strategy behind the acquisition.

The disclosure would also typically include one or more risk factors relating to the consummation of the acquisition (if the offering is made in advance of the closing of the acquisition), the prospects of the target's business and the issuer's ability to successfully integrate the business of the target into the issuer's enterprise.

Target Disclosure

In some cases, the transactional disclosure may not be considered sufficient given the size, trends, costs or other potential impacts on the issuer of its acquisition of the target company or assets. Set forth below are examples of additional disclosures that an issuer may consider.

Management's Discussion and Analysis for Target

When historical financial statements of the target have been included in the prospectus of an acquiror engaging in a securities offering, consideration should be given to the inclusion of a "Management's Discussion and Analysis" or "MD&A" in relation to the target historical financial statements, particularly where the target is a 1934 Act reporting company, the acquisition is friendly and the target has agreed to cooperate with the issuer in connection with its due diligence. The purpose of an MD&A is to provide management's insight into the historical data set out in the financial statements. While not technically required by Regulation S-X or Regulation S-K, the inclusion of such information could assist in insulating the issuer against criticism that investors were not provided with an adequate ability to interpret the financial statements of the target so as to enable them to make an informed investment decision with respect to the securities to be issued by the acquiror. On the other hand, as the MD&A for a target is really the province of the target's management,

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the issuer should perform adequate due diligence to ensure it is comfortable with including the target's MD&A.

Business Section for Target

Where the business of a target would comprise a material portion of the combined enterprise, consideration should be given to the inclusion of an in-depth business description of the target, especially when the target and the issuer are engaged in different lines of business or engage in businesses in different industries or geographic regions. To the extent that the business of the combined operation would be comprised in significant part of the operations of the target, the absence of such disclosure could give rise to criticism that the disclosure did not fully describe the business of the issuer or the potential impact of the acquisition on the issuer's existing business, management, etc. As with the target's MD&A, the issuer should perform adequate due diligence to consider the accuracy of the target business disclosure it does include in its prospectus or other offering document.

Risk Factors Relating to Business of Target

Risk factors relating to the business of the target may warrant inclusion in the prospectus or other offering document, particularly in circumstances where the target will comprise a significant component of the combined enterprise and the target's business varies from that of the issuer. If a significant portion of the business of the combined entity would be the target's business, the risk factors relating to the business of the target would, in effect, relate to the combined enterprise.

Incorporation by Reference

Under circumstances where the issuer has concluded that in-depth disclosure in relation to the target, beyond that required by Regulation S-X, is necessary to ensure adequate disclosure, it may, in lieu of reciting such information in whole in the prospectus, consider incorporating such information by reference to the target's 1934 Act reports.[546]

Other Disclosures

The facts and circumstances of the offering and the acquisition may make it advisable to include other disclosure in the prospectus or other offering document. For example, a capitalization table as adjusted for the acquisition and as further adjusted for the offering of the securities and the use of the proceeds therefrom is frequently included in connection with acquisition financings.

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[546] While we are not aware of any specific written or oral advice of the Staff that would authorize such an approach in an SEC registered offering, this method of proceeding has been done and is consistent with a literal reading of Rule 411(b) and (c) under the 1933 Act.

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Factors Impacting Degree of Historical Target Disclosure

Various factors should be considered in determining the extent of the added disclosure in relation to the transaction and the target.

Size of Target Relative to Issuer

The size of the target relative to the issuer is among the most important of the factors to consider. The importance of disclosure concerning the target increases in direct proportion to the relative size that the target bears to the issuer (although see below under "Same or Different Industries"). As the proportion of the combined enterprise is attributable to the target's business increases, so does the need for disclosure in relation to the target in order for investors in the offering to be informed of the nature of the issuer whose securities they will be owning. In addition, as noted above, as the size of the target relative to the issuer increases, so do the requirements for historical and pro forma financial statements of the target. The Regulation S-X requirements for historical and pro forma financial statements create a corresponding need to consider whether an accompanying MD&A is advisable or necessary.

Same or Different Industries

Whether the issuer and the target operate in the same industry or line of business will also impact the analysis concerning the degree of information that should be included in the offering document in relation to the target. Where the issuer and the target are in the same line of business, a case can be made that added disclosure in relation to the target is less important and that disclosure in relation to the anticipated size of the combined enterprise is the most material element to the transaction. Conversely, in the case of a large acquisition of a target engaged in a different line of business that will fundamentally alter the business of the issuer, the importance of added disclosure is greater, particularly if such an acquisition would result in a fundamental change in the nature of the issuer's business.

Hostile versus Friendly

While the adequacy of disclosure in the offering document is the most important factor to consider in determining the degree of disclosure in relation to the target to include in the offering document, access to such disclosure may nevertheless impact the extent to which, and the manner in which, information concerning the target is provided in the offering document. In circumstances where the target is being acquired in a "hostile" transaction, the issuer may not have access to information concerning the target or the ability to sufficiently diligence that information. Under such circumstances, disclosure that is less robust than would otherwise have been the case, or a simple reference in the prospectus to the 1934 Act reports of the target without incorporating the same by reference, could be the only option available and thus be justified in light of the circumstances. On the other hand, in

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circumstances where the target is being acquired in a "friendly" transaction, the issuer may have better access to information concerning the target and the cooperation of the target to enable it to get comfortable with including more information about the target.[547]

Issues to Consider in Providing Inclusion of Historical Target Data

Liability In Relation to Target Information

As discussed above, in order to ensure the adequacy of disclosure in the offering document of an issuer engaging in an acquisition, often times robust disclosure in relation to the target may be considered advisable or necessary. On the other hand, the inclusion of such information in the offering document of the issuer will subject the issuer and the underwriters to potential liability on account of material misstatements or omissions in the disclosure concerning the target. It is therefore important to note the different liability provisions associated with such disclosure.

In connection with an offering that will be registered under the 1933 Act, in addition to the liability provided by the general anti-fraud provisions of the 1934 Act, the issuer will be subject to the provisions of Section 11 under the 1933 Act. Liability for an issuer under Section 11 of the 1933 Act for misstatements or omissions in its prospectus is absolute inasmuch as Section 11 does not provide an issuer with a "due diligence" defense in relation to the disclosure contained in its prospectus. Accordingly, any misstatement or omission in relation to a material fact in the prospectus, including with respect to disclosure concerning the target, will result in liability under Section 11 of the 1933 Act, regardless of the steps taken by the issuer to ensure the accuracy of the disclosure in its prospectus. In most circumstances, the issuer will not have participated in the preparation of the disclosure concerning the target that is included in the prospectus. Thus, under such circumstances, the issuer will be subject to absolute liability in relation to disclosure that it did not prepare or in the preparation of which it did not participate.[548]

In light of the foregoing, the issuer may consider issuing securities in a private placement in reliance upon an exemption from the registration requirements of the 1933 Act. Liability for misstatements or omissions in relation to material facts in the offering document would thereby be limited to general anti-fraud provisions of applicable law, including the anti-fraud provisions of Rule 10b-5 under the 1934 Act. Liability under such provisions is

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[547] In connection with a friendly acquisition where the acquiror is anticipating a securities transaction to fund all or a portion of the acquisition price, it is customary for the related merger or asset purchase agreement to contain a covenant on the part of the target that would require it to cooperate with the acquiror in connection with the securities transaction, particularly with respect to disclosure and related due diligence matters.

[548] It should be noted, however, that following the consummation of the acquisition, the issuer/acquiror will assume all of the liabilities of the target that it acquires, including liability on account of material misstatements or omissions in the target's 1934 Act reports filed prior to the consummation of the acquisition.

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not absolute and requires the person bringing such a claim to prove the existence of "*scienter*" in relation to the material misstatement or omission. In general, *scienter* is interpreted as an actual intent to defraud or reckless disregard for the accuracy of the statements in the offering document. While this approach offers significant benefits for the issuer, often times registration rights are required in connection with privately placed securities. Accordingly, while the issuer would avoid the absolute liability provisions of Section 11 under the 1933 Act in connection with the initial placement of the securities, the issuer would be forced to assume such liability with respect to the prospectus delivered pursuant to the registration rights agreement.[549]

Ongoing 1934 Act Presentation

It is important to note that decisions made in relation to the appropriate level of disclosure concerning the target will impact not only the disclosure in the related prospectus or offering document, but may also serve as a compelling guideline for the approach that the issuer will take in its 1934 Act reports filed subsequent to the completion of the offering. Accordingly, any sensitivity by the issuer in relation to the liability issues discussed above will exist until such time as the description of the business acquired becomes a part of the issuer's description of its own business.

Issuances During Pendency of 75-Day Period

As noted above under "General Financial Statement Requirements – Target Historical Financial Statement Requirements," when an acquisition exceeds any of the 20% level of significance criteria but does not exceed any of the 50% level of significance criteria, historical and pro forma financial information relating to the target will not be required by Regulation S-X to be included in the prospectus provided that the prospectus is dated as of a date that is no more than seventy-four calendar days after the date of the consummation of the acquisition. In addition, within approximately seventy-five days of the date of the consummation of the acquisition, historical and pro forma financial statements will be required to be filed by the issuer on a Current Report on Form 8-K pursuant to the 1934 Act.[550] Though not required by the technical provisions of Regulation S-X, consideration

[549] Where such added target disclosure is not technically mandated by the 1933 Act, the issuer theoretically could omit such information and comply with the applicable requirements of the 1933 Act in relation to the resale prospectus. Such an approach, however, may not be practical in addressing the issuer's liability concerns given that such an approach could subject the issuer to claims that the disclosure in the resale prospectus is deficient, particularly when compared with the disclosure in the original offering document.

[550] See Section 2050.1 of the Financial Reporting Manual. The actual technical requirement, as noted above, for the filing of a Current Report on 8-K is seventy-one days from the date of the filing of the original Current Report on Form 8-K announcing the consummation of the acquisition, which original filing is required to be made within four business days of the date of consummation. The sum of four business days and seventy-one calendar days can be different than seventy-five calendar days. However, the Staff, in circumstances relating to a not yet effective registration statement, will consider these two periods to be substantially the equivalent of one another.

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should nevertheless be given to the materiality of such financial statements notwithstanding the technical requirements of Regulation S-X, especially since the issuer will in any event be required to provide such financial statements on a Current Report on Form 8-K. Additional disclosures concerning the target as discussed above should also be considered.

When Significance is Less than 20%

When an acquisition does not exceed the 20% level of any of the significance criteria, there is no requirement for historical or pro forma financial statements with respect to the target. Nevertheless, in determining the extent of the disclosure in relation to the acquisition in the prospectus or other offering document, consideration should be given to the materiality of the transaction to the business of the issuer. On the one hand, a minor acquisition in the ordinary course of the issuer's business may not even warrant disclosure in a "Recent Developments" section. On the other hand, where an acquisition is at or slightly below the 20% level of the significance criteria, offering materials that omit robust disclosure in relation to the target solely on the basis of the technical provisions of Regulation S-X could be subject to criticism in the case of an acquisition that is material to the issuer's business.

Due Diligence in Relation to the Target

To the extent that information concerning the target is included in the prospectus (whether by incorporation by reference to such target's 1934 Act reports or otherwise), underwriters and their counsel should request a due diligence procedure commensurate with the due diligence that would be undertaken with respect to the issuer.

In circumstances where significant portions of the target's 1934 Act reports are included in the prospectus or offering document relating to the offering, including a Management's Discussion and Analysis and business description, the underwriters will likely require a comfort letter that ties financial data in such sections back to the target's financial statements or financial records, as the case may be. In such circumstances, and where counsel is asked to provide a disclosure statement with respect to the prospectus or offering document as a whole, counsel will also likely request the opportunity to conduct a "document" due diligence review with respect to the target that is commensurate with the document due diligence it will perform with respect to the issuer. The underwriters may also request senior management of the target to participate in an "interview" due diligence session substantially of the scope of that conducted in relation to the issuer. Finally, to the extent that pro forma financial statements are included in the prospectus, the underwriters, in addition to standard accounting comfort in relation to the pro forma financial statements, may also request the issuer to provide the financial models used by the issuer to assess the reasonableness of the related adjustments upon which the pro forma financial statements are based. These models are frequently prepared by the financial advisor (which may or may not be one of the underwriters in the related securities offering) that advised the issuer on the acquisition transaction.

In circumstances where financial statements of the target are included but less than a robust description of the target is included, underwriters and their counsel will likely request

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a comfort letter with respect to the target financial statements. This comfort letter should include all of the requirements of a standard comfort letter but would only include "tick and tie" comfort to the extent of the more limited disclosure in relation to the target included in the prospectus. The scope of legal counsel's due diligence will depend on the facts and circumstances surrounding the acquisition and the related disclosure.

As noted above, where the securities offering is registered under the 1933 Act, the issuer will have strict liability for the disclosure included in its prospectus in relation to the target. However, a robust due diligence of the target would nevertheless assist in protecting the issuer against liability for disclosure concerning the target. In addition, where the offering is pursuant to an exemption from the registration requirements of the 1933 Act, the issuer's liability will not be absolute and will instead depend, in part, on the required element of *scienter* on the part of the issuer in relation to any material misstatement or omission. A robust due diligence process could assist the issuer in establishing that it did not act with *scienter* in relation to an alleged material misstatement or omission contained in the disclosure concerning the target.

PRIVATE PLACEMENTS VERSUS REGISTERED OFFERINGS

The foregoing discussion focuses on the requirements for target historical and pro forma financial statements for offerings registered under the 1933 Act and additional disclosures in relation to the target where the facts and circumstances so warrant. However, there are circumstances where the issuer, the investment bank, and counsel involved in the securities offering could be comfortable in proceeding with the offering in the absence of providing the historical and pro forma financial statements otherwise mandated for offerings registered under the 1933 Act. In such circumstances, the issuer could proceed with an offering that is exempt from the registrations requirements of the 1933 Act marketed to qualified institutional buyers in reliance upon Rule 144A under the 1933 Act, or directly placed by the issuer with investors in reliance upon Section 4(a)(2) under the 1933 Act.

While the 1933 Act does not mandate any disclosure in relation to offerings conducted in reliance upon Rule 144A under the 1933 Act, the anti-fraud provisions of the 1934 Act, and in particular Rule 10b-5 thereunder, remain applicable. As a result, in order to refute any potential fraud claims by purchasers in private placements, it is generally the convention for offering documents used in connection with Rule 144A offerings of many types of securities to include the disclosure that would have been included in the offering document had the offering been registered under the 1933 Act. Nevertheless, where the disclosure otherwise mandated by the 1933 Act for the offering is viewed by those involved in the offering as not being material, those involved in the offering process may proceed in the absence of such disclosure, particularly where the issuer has a compelling reason to do so. Most frequently, such decisions will be based on timing considerations where the issuer requires funds prior to the time that the related target disclosure will be available, especially where the target is not an entity that files reports with the SEC pursuant to the 1934 Act.

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STRUCTURAL CONSIDERATIONS AND FORMAT OF THE SECURITIES OFFERING

In addition to the impact of an acquisition on disclosure, acquisition finance also implicates structural issues to consider when issuing particular classes of securities.

Mandatory Redemption if Acquisition is not Consummated

When securities are issued in order to finance in whole or in part a pending acquisition, if the acquisition were to fail to be consummated, the issuer could be saddled with indebtedness that it would not otherwise have incurred and with proceeds for which it has no use. Also, investors may not want to stay invested in the issuer if the acquisition is not consummated. It is therefore not uncommon for debt securities issued under such circumstances to include a mandatory redemption feature that requires the issuer to repurchase the securities, sometimes at a slight premium, if the acquisition fails to be consummated. Especially in instances involving issuers of high-yield debt, offerings to fund a pending acquisition may contemplate an escrow arrangement pursuant to which the proceeds of the offering are to be deposited into an escrow account. Such arrangements provide for the release of the funds from the escrow account upon the earlier to occur of the satisfaction of the closing conditions for the acquisition or a specified date certain upon which the escrow arrangement will terminate. If the closing conditions for the acquisition are satisfied prior to the escrow termination date, the arrangements typically provide for the release of the escrowed funds in order to fund the purchase price for the acquisition. If the closing conditions are not satisfied prior to the escrow termination date, the funds would be released to fund the repurchase price payable to holders of the securities upon mandatory repurchase.

Convertible Securities

Certain U.S. Federal Income Tax Considerations Applicable to Subordinated Convertible Debt

To comply with certain Treasury regulations, we state that the following discussions are not intended or written to be legal or tax advice to any person and are not intended or written to be used, and they cannot be used, by any person for the purpose of avoiding any U.S. federal tax penalties that may be imposed on such person. Each person should seek advice based on its particular circumstances from its own tax advisor.

Notwithstanding anything to the contrary contained herein, each person (and each employee, representative, or other agent of each person) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the transactions described herein, and all materials of any kind that are provided to such person relating to such tax treatment and tax structure (as such terms are defined in applicable Treasury regulations). This authorization of tax disclosure is retroactively effective to the commencement of discussions regarding the transactions contemplated herein.

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Under Section 279 of the Internal Revenue Code, a corporation may not deduct from gross income any interest paid or incurred during a taxable year with respect to its "corporate acquisition indebtedness" (as defined below) to the extent that such interest exceeds an amount equal to $5,000,000 minus the amount of interest paid or incurred by such corporation during such year on certain obligations issued after December 31, 1967, to provide consideration for certain acquisitions but which obligations do not constitute corporate acquisition indebtedness. For these purposes, corporate acquisition indebtedness includes any obligation evidenced by a bond, debenture, note, certificate or other indebtedness if:

(i) such obligation is issued to provide consideration for the acquisition of stock in another corporation or, in certain circumstances, assets in another corporation;

(ii) such obligation is either subordinated to the claims of trade creditors of the issuer generally or expressly subordinated in right of payment to the payment of any substantial amount of unsecured indebtedness, whether outstanding or subsequently issued, of the issuer;

(iii) such obligation is either convertible directly or indirectly into stock of the issuer or part of an investment unit or other arrangement which includes an option to acquire stock in the issuer, and

(iv) as of the last day of any taxable year in which the issuer issues any obligation to provide consideration for an acquisition described above, the ratio of debt to equity of the issuer exceeds 2 to 1 or the issuer's projected earnings do not exceed 3 times the annual interest to be paid or incurred.

In the case in which the issuer is a member of an affiliated group, the application of Section 279 of the Internal Revenue Code is determined by treating all of the members of the affiliated group in the aggregate as the issuer.

Direct or Indirect Acquisition

Obligations are issued to provide direct consideration for an acquisition for purposes of Section 279 of the Internal Revenue Code where the obligations are issued to the shareholders of an acquired corporation in exchange for stock in such acquired corporation or where the obligations are issued to the acquired corporation in exchange for its assets. The application of the provisions relating to indirect consideration for an acquisition of stock or assets depends upon the facts and circumstances surrounding the acquisition and the issuance of the obligations. In general, obligations are issued to provide indirect consideration for an acquisition of stock or assets within the meaning of Section 279 of the Internal Revenue Code where (i) at the time of the issuance of the obligations the issuer anticipated the acquisition of such stock or assets and the obligations would not have been issued if the issuer had not so anticipated such acquisition, or (ii) at the time of the acquisition the issuer foresaw or reasonably should have foreseen that it would be required to issue obligations,

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which it would not have otherwise been required to issue if the acquisition had not occurred, in order to meet its future economic needs.

Subordination

An obligation which is issued to provide consideration for an acquisition covered by Section 279 of the Internal Revenue Code is subordinated for purposes of Section 279 of the Internal Revenue Code if it is either (1) subordinated to the claims of trade creditors of the issuing corporation generally, or (2) expressly subordinated in right of payment to the payment of any substantial amount of unsecured indebtedness, whether outstanding or subsequently issued, of the issuing corporation, irrespective of whether such subordination relates to payment of interest, principal or both. An obligation is considered expressly subordinated whether the terms of the subordination are provided in the evidence of indebtedness itself, or in another agreement between the parties to such obligation. An obligation shall be considered to be expressly subordinated if such obligation by its terms can become subordinated in right of payment to the payment of any substantial amount of unsecured indebtedness which is outstanding or which may be issued subsequently. However, an obligation shall not be considered expressly subordinated if such subordination occurs solely by operation of law, such as in the case of bankruptcy laws.

Debt to Equity/Projected Earnings

Under Section 279 of the Internal Revenue Code, the term “ratio of debt to equity” means the ratio which the total indebtedness of the issuing corporation bears to the sum of its money and all its other assets (in an amount equal to the adjusted basis for determining gain) less such total indebtedness.

Section 279 of the Internal Revenue Code may apply if the projected earnings of the issuer, or of both the issuer and the acquired corporation in any case where the issuing corporation as of the close of its taxable year has acquired control or has acquired substantially all of the properties of the acquired corporation, do not exceed three times the annual interest to be paid or incurred by the issuer, or, where applicable, by the issuer and the acquired corporation. The term “projected earnings” means the “average annual earnings” for any corporation, the amount of its earnings and profits for any three-year period ending with the last day of a taxable year of the issuer in which it issues any obligation to provide consideration for an acquisition described in Section 279 of the Internal Revenue Code, computed without reduction for (1) interest paid or incurred, (2) depreciation or amortization, (3) liability for tax, and (4) distributions treated as dividends.

The ultimate applicability of Section 279 of the Internal Revenue Code to any particular transaction depends upon the specific facts and circumstances involved. Accordingly, any particular transaction should be closely analyzed. In addition, due to the factual nature of the inquiry, careful planning and structuring could avoid the application of Section 279 of the Internal Revenue Code.

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Shareholder Consent Provisions for NASDAQ-Listed Issuers

The general exemption from the shareholder consent requirements of the NASDAQ Stock Market Rules applicable to typical private placements of convertible debt is not applicable in the context of an offering of convertible debt issued for acquisition finance purposes.

Rule 5635 of the NASDAQ Stock Market Rules sets forth the circumstances under which shareholder consent is required in connection with the issuance of equity or equity linked securities in a private placement.

The provisions of Rule 5635(d) relate generally to private placements and provide that shareholder consent will be required prior the issuance of common stock, or securities convertible into or exercisable for common stock, in an amount that exceeds 20% or more of the voting power outstanding immediately prior to the issuance. However, Rule 5635(d) exempts offerings of common stock where such common stock is issued at a price that is not less than the greater of book or market value (the "greater of book or market exemption") from the shareholder consent provisions of the rule. Unless the common stock is trading at such a discount to the book value per share such that even after giving effect to the conversion premium, the conversion price would still be below book value per share, the conversion premium of a convertible instrument will generally qualify the issuance for this exemption.

If convertible debt is issued pursuant to a private placement for acquisition finance purposes, however, the provisions of Rule 5635(a) will, in addition to the provisions of Rule 5635(d), be applicable to the convertible debt issuance. The provisions of Rule 5635(a) requiring shareholder consent are substantially the same as the provisions of Rule 5635(d) (*i.e.*, the rule is implicated in connection with a private placement where the underlying securities would exceed 20% or more of the voting power outstanding prior to the issuance) with one critical exception: Rule 5635(a) does not provide for the greater of book or market exemption. Accordingly, the requirement for shareholder consent set forth in Rule 5635(a) will be absolute in circumstances where the underlying common stock would exceed 20% or more of the voting power outstanding prior to the issuance. Accordingly, in circumstances where an acquisition is to be financed by the issuance of convertible debt where the underlying shares represent 20% or more of the voting power outstanding prior to the issuance, a NASDAQ-listed issuer would be required to proceed with the issue on an SEC-registered basis in order to avoid the shareholder consent provisions of Rule 5635(a).

The shareholder consent provisions set forth in Section 312.03 of the New York Stock Exchange Listed Company Manual do not have a provision similar to Rule 5635(a) of the NASDAQ Stock Market Rules. Accordingly, if an issuer were to issue convertible securities and if the conversion price were to equal at least the greater of market or book value per share, the issuance would not be subject to the shareholder consent provisions of 312.03 of the New York Stock Exchange Listed Company Manual, regardless of whether the proceeds are used for acquisition finance purposes.

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GLOSSARY

10b-5 statement.................................	statement to the underwriters by U.S. counsel that confirms nothing has come to such counsel's attention to cause it to believe that the registration statement (in the case of a 1933 Act-registered offering) or the offering documents (in the case of a 1933 Act-exempted offering) do not contain or incorporate by reference (in the case of a 1933 Act-registered offering) any information required to be stated therein or contain or incorporate by reference (in the case of any offering) any material misstatement or omit any material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading
18(b)(1)(C) Covered Securities..........	securities exempt from U.S. state or territorial regulation under Section 18(b)(1)(C) of the 1933 Act
18(b)(4)(C) Covered Securities..........	securities exempt from U.S. state or territorial regulation under Section 18(b)(4)(C) of the 1933 Act
1933 Act...	Securities Act of 1933
1934 Act...	Securities Exchange Act of 1934
1939 Act...	Trust Indenture Act of 1939
1940 Act...	Investment Company Act of 1940
1986 Release	defined on page 325
2007 Regulation D Amendments Proposing Release.............................	defined on page 258
accelerated filer.................................	defined in Rule 12b-2 under the 1934 Act as an issuer after it first meets the following conditions as of the end of its fiscal year: (i) the issuer had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $75 million or more but less than $700 million, as of the last business day of the issuer's most recently completed second fiscal quarter; (ii) the issuer has been subject to the requirements of Section 13(a) of the 1934 Act (*i.e.*, has securities listed on a U.S. securities exchange) or 15(d) of the 1934 Act (*i.e.*, had a 1933 Act registration statement become effective) for at least twelve calendar months; (iii) the issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the 1934 Act; and (iv) the issuer is not eligible to use the SEC's

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	rules for smaller reporting companies
ADRs	American depositary receipts issued by a depositary, typically a U.S. bank, that evidence a direct interest in underlying securities held by the depositary
ADSs	American depositary shares are securities (or a fraction or multiple thereof) that are evidenced by an ADR and that represent underlying securities held by or on behalf of the depositary that issued the ADR
ADTV	average daily trading volume
affiliated purchaser	defined on page 60
antitrust agencies	U.S. Federal Trade Commission and U.S. Department of Justice
at-the-market offering	an offering of securities into an existing trading market at other than a fixed price
audit committee financial expert	defined on page 12
bank issuers	U.S. banks and U.S. branches and agencies of non-U.S. banks
bank notes	bank securities that include senior or subordinated bank-level debt securities
bank securities	securities issued by U.S. banks and U.S. branches and agencies of non-U.S. banks
BHCA	Bank Holding Company Act of 1956
blue sky laws	securities laws adopted by U.S. states and territories
business combination	generally, mergers, asset sales and other transactions resulting in financial benefit to a stockholder
Canadian issuer	any non-U.S. issuer (other than an investment company) incorporated or organized under the laws of Canada or any Canadian province or territory
CEO	Chief executive officer
CFO	Chief financial officer
CFIUS	Committee on Foreign Investment in the United States
CFTC	Commodity Futures Trading Commission
consideration cap	total consideration that an issuer will pay under a modified “Dutch auction” tender offer
Cross-Border Rules	defined on page 384
CUSIP	Committee on Uniform Security Identification Procedures
deposit notes	certificates of deposit structured to resemble debt securities
depositary	a bank organized in the United States that provides the security transfer and agency services in connection with an ADR or GDR facility

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disclosure package	defined on page 38
DFA Resolution Plan Rule	defined on page E-7
DOWNREIT	defined on page 308
DTC	The Depository Trust Company
EDGAR	Electronic Data Gathering, Analysis and Retrieval system, the SEC's electronic filing system
EGCs	emerging growth companies
ELDS	equity-linked debt securities
ELTN	equity-linked term note
Exon-Florio	defined on page 388
FASB	Financial Accounting Standards Board
FCPA	Foreign Corrupt Practices Act of 1977
FDI Act	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
Federal Reserve Board	Board of Governors of the U.S. Federal Reserve System
FFO	funds from operations
FHC	financial holding companies
FIO Act	Federal Insurance Office Act of 2010
financial services affiliate	defined on page 64
FINRA	Financial Industry Regulatory Authority, Inc.
foreign governmental issuer	any government of any country other than the United States or any of its political subdivisions, and any other entity that the SEC determines is eligible for similar treatment in connection with U.S. public offerings
foreign private issuer	defined on page 2
FRA	Federal Reserve Act
free writing prospectus	defined on page 38
FSOC	Financial Stability Oversight Council
GAAP	Generally accepted accounting principles
GDRs	Global depositary receipts issued by a depositary, typically a bank, that evidence a direct interest in underlying securities held by the depositary
graphic communications	defined on page 42
HSR Act	Hart-Scott-Rodino Antitrust Improvements Act of 1976
hybrid REIT	defined on page 309
IBA	International Banking Act of 1978
IDRs	incentive distribution rights
IFRS	International Financial Reporting
Industry Guide	SEC regulations covering required disclosure for issuers in certain industries, as available at http://www.sec.gov/about/forms/industryguides.pdf
ineligible issuer	defined on page 34

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integrated disclosure system	defined on page 8
Internal Revenue Code.......................	Internal Revenue Code of 1986, as amended
investment company	defined on page 22
IPO	Initial Public Offering
ITSFEA	Insider Trading and Securities Fraud Enforcement Act of 1988
JOBS Act	Jumpstart Our Businesses Startups Act of 2012
large accelerated filer.........................	defined in Rule 12b-2 under the 1934 Act as an issuer after it first meets the following conditions as of the end of its fiscal year: (i) the issuer had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $700 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter; (ii) the issuer has been subject to the requirements of Section 13(a) of the 1934 Act (*i.e.*, has securities listed on a U.S. securities exchange) or 15(d) of the 1934 Act (*i.e.*, had a 1933 Act registration statement become effective) for at least twelve calendar months; (iii) the issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the 1934 Act; and (iv) the issuer is not eligible to use the SEC's rules for smaller reporting companies.
MD&A	the section of a disclosure document under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" or a similar heading that discusses issuer's financial condition and results of operations
MJDS	Multi-jurisdictional Disclosure System
MLP	master limited partnership
MQD	minimum quarterly distribution
MVPHS...	market value of publicly-held shares
NAIC...	National Association of Insurance Commissioners
NAREIT	National Association of Real Estate Investment Trusts
NASAA...	North American Securities Administrators Association
NASD..	National Association of Securities Dealers, Inc.
NASDAQ	National Association of Securities Dealers Automated Quotation System
NASDAQ Corporate governance rules..	Rules 4350 and 4351 of NASD Manual
NASDAQ security	defined on page 64
national securities exchange	any U.S. securities exchange regulated as such

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	under the 1934 Act
non-expertised	defined on page 361
non-GAAP financial measure	defined on page 77
non-reporting issuer	issuer that does not file 1934 Act reports with the SEC voluntarily or otherwise
non-U.S. issuer	any issuer that is a government (other than the government of the United States or any of its political subdivisions), a national of any country (other than the United States) or a corporation or other organization incorporated or organized under the laws of any such country or any of its political subdivisions
NRSRO	nationally recognized statistical ratings organization
NSMIA	National Securities Markets Improvement Act of 1996
NYSE	New York Stock Exchange, Inc.
NYSE MKT	the name of the U.S. securities exchange formerly referred to as the American Stock Exchange prior to its acquisition by NYSE Euronext.
NYSE MKT Initial Listing Standards	defined on page 188
OCC	Office of the Comptroller of the Currency of the Department of the Treasury
OFAC	Office of Foreign Assets Control of the U.S. Department of the Treasury
offering memorandum	a disclosure document used for an offering that is not registered under the 1933 Act; also referred to as an "offering circular"
Part 8	Part 8 of the NYSE MKT Company Guide contains corporate governance requirements for companies listed on that exchange
PCAOB	U.S. Public Company Accounting Oversight Board
plain English	SEC requirement regarding writing principles and techniques that produce disclosure that is easy to read, including the use of pictures, logos, charts, graphs and other similar design features
prospectus	primary offering document for a securities offering registered under the 1933 Act
proxy	defined on page 9
PSLRA	Private Securities Litigation Reform Act of 1995
QIB	qualified institutional buyer as defined in Rule 144A
QIU	qualified independent underwriter
QLCC	defined on page 233
QRS	qualified REIT subsidiary
reference security	defined on page 61

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Term	Definition
Regulation FD	Regulation FD under the 1934 Act
Regulation G.	SEC Regulation containing disclosure requirements relating to "non-GAAP financial measures"
Regulation M-A.	SEC Regulation containing certain requirements relating to mergers and acquisitions
Regulation S	Regulation S under the 1933 Act
Regulation W	defined on page E-3
REIT	real estate investment trust
Related Party	for purposes of the NYSE rules, a director, officer or substantial securityholder of an issuer
resource extraction issuer	defined on page 104
restricted securities	defined on page 261
Rule 144A	Rule 144A under the 1933 Act
Rule 144A offering	a private placement that is sold to QIBs by underwriters or agents pursuant to Rule 144A under the 1933 Act
Sarbanes-Oxley	Sarbanes-Oxley Act of 2002
SDNs	Specially Designated Nationals and Blocked Nationals
seasoned issuer	those issuers that do not qualify as WKSIs but that are eligible to make primary offerings of securities on Form S-3 or Form F-3
SEC	Securities and Exchange Commission
Securities Offering Reform	the SEC interpretations and rule and form changes adopted by the SEC in SEC Release No. 33-8591 (July 19, 2005)
senior bank notes	defined on page 314
SFAS 131	Statement of Financial Accounting Standards No. 131
solicitation	defined on page 9
subject security	defined on page 61
subordinated bank notes	defined on page 314
SUSMI	substantial U.S. market interest
time of sale	time at which an investor becomes committed to purchasing a security
TRS	taxable REIT subsidiary
unseasoned issuer	issuers that are required to file reports under the 1934 Act but are ineligible to make primary offerings on Form S-3 or F-3
UPREIT	umbrella partnership REIT
U.S. issuer	any issuer other than a non-U.S. issuer
U.S. person	defined on page 267
USA PATRIOT Act	Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001

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Volcker Rule	Section 619 of the Dodd-Frank Act
WKSI	well-known seasoned issuer, as defined in Rule 405 under the 1933 Act
written communication	any written material, graphic communication or radio or television presentation, without regard to the manner of transmission
XBRL	eXtensible business reporting language

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APPENDIX A

NYSE AND NASDAQ:
LISTING REQUIREMENTS FOR COMMON STOCK

APPENDIX A

NYSE AND NASDAQ:
LISTING REQUIREMENTS FOR COMMON STOCK

Distribution Requirements for Common Stock	
NYSE	• At least 1.1 million publicly-held shares in the United States; • At least 400 round lot holders in the United States; and • Aggregate market value of publicly-held shares in the United States in excess of $100 million ($40 million in the case of an IPO or spin-off or under the NYSE's affiliated company standard)
NYSE Arca	• At least 1 million publicly-held shares; • Initial public offering price of at least $5 (for an IPO) or a closing price of at least $5 per share based on the ninety-day average prior to applying for listing and which cannot fall below $1 per share during such ninety-day period; • At least 400 round lot holders; • Aggregate market value of publicly-held shares of at least $45 million; and • At least $150 million in total market capitalization (based on the ninety-day average prior to applying for listing)
NYSE MKT	Issuers must satisfy **one** of the following requirements: • 500,000 publicly-held shares in the United States and a minimum of 800 U.S. public shareholders; or • 1 million publicly-held shares in the United States and a minimum of 400 U.S. public shareholders; or • 500,000 publicly-held shares in the United States and a minimum of 400 U.S. public shareholders and an average daily trading volume of 2,000 shares or more for the six months preceding the date of the listing application
Nasdaq Capital Market	• At least 1 million publicly-held shares (excluding shares held by any officers, directors or 10% shareholders); • At least 300 round lot holders; • At least three market makers; and • A minimum $4 per share bid price

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Nasdaq Global Market	• At least 1.1 million publicly-held shares (excluding shares held by any officers, directors or 10% shareholders); • At least 400 round lot holders; • At least three market makers; and • A minimum $4 per share bid price
Nasdaq Global Select Market	• At least 1,250,000 publicly-held shares (excluding shares held by any officers, directors or 10% shareholders); • Either 450 round lot holders or 2,200 beneficial shareholders or, in the case of seasoned issuers[551] or affiliated issuers,[552] 550 beneficial shareholders and an average monthly trading volume of $1.1 million over the past twelve months; • At least $45 million market value of publicly-held shares ("MVPHS") or, in the case of seasoned issuers, either $110 MVPHS or $100 million MVPHS and $110 million of shareholders' equity; • At least three market makers; and • A minimum $4 per share bid price

[551] Nasdaq considers an issuer to be a "seasoned issuer" if it is already listed or quoted on another marketplace.

[552] Nasdaq considers an issuer to be an "affiliated issuer" if it is affiliated with another company listed on the Nasdaq Global Select Market, if such other company, directly or indirectly though one or more intermediaries, controls, is controlled by, or is under common control with, the issuer. For this purpose, control means having the ability to exercise significant influence, which is presumed to exist where the parent or affiliated company directly or indirectly owns 20% or more of the issuer's voting securities, and also can be indicated by representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel or technological dependency.

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Financial Requirements for Issuers of Common Stock	
NYSE	Issuers must meet **one** of the following requirements: • Pre-tax income of at least $10 million in the aggregate for the latest three fiscal years, the third of which must be profitable, with at least $2 million of pre-tax income for each of the two most recent fiscal years; • Pre-tax income of at least $12 million in the aggregate for the last three fiscal years, with at least $5 million of pre-tax income in the most recent year and at least $2 million of pre-tax income in the next most recent year; • At least $500 million of market capitalization, with at least $100 million in revenues in the most recent twelve-month period and aggregate cash flow of $25 million for the last three years, all of which must be profitable; • At least $750 million of market capitalization and at least $75 million of revenues during the most recent fiscal year; • At least $500 million of market capitalization, have been operating for at least twelve months, and have a parent or an affiliated company that is listed and is in good standing, and the parent or affiliated listed company must retain control of the issuer or be under common control with the issuer; or • At least $150 million of market capitalization, with at least $75 million in total assets and $50 million in stockholders' equity
NYSE Arca	Issuers must meet **two** of the following requirements: • Total assets of at least $75 million; • At least $50 million in revenues for the most recent fiscal year (or two of the last three years); • Shareholders' equity of at least $50 million; • Pre-tax income must be positive for the latest fiscal year
NYSE MKT	Issuers must meet **one** of the following requirements: • Stockholders' equity of at least $4 million, pre-tax income of at least $750,000 in its last fiscal year or in two of its last three fiscal years and an aggregate market value of publicly-held shares of $3 million with a minimum market price of $3 per share; • Stockholders' equity of at least $4 million, at least two years of operation and an aggregate market value of publicly-held shares of $15 million with a minimum market price of $3 per share; • Stockholders' equity of at least $4 million, market capitalization of $50 million and an aggregate market value of publicly-held shares of $15 million with a minimum market price of $2 per share; or • Market capitalization of $75 million, or total assets and total revenue of $75 million each in its last fiscal year, or in two of its last three fiscal years, and an aggregate market value of publicly-held shares of $20 million with a minimum market price of $3 per share

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Financial Requirements for Issuers of Common Stock	
Nasdaq Capital Market	Issuers must meet **one** of the following requirements: • Stockholders' equity of $5 million, $15 million market value of publicly-held shares ("MVPHS"), and operating history of two years; • Stockholders' equity of $4 million, $15 million MVPHS, and $50 million market value for listed securities (Nasdaq or other national securities exchange); or • Stockholders' equity of $4 million, $5 million MVPHS, and net income from continuing operations of at least $750,000 in the last fiscal year or in two of the last three fiscal years
Nasdaq Global Market	Issuers must meet **one** of the following requirements: • Stockholders' equity of $15 million, income of $1 million from continuing operations before income taxes in the latest fiscal year or in two of the last three fiscal years, three market makers, and $8 million MVPHS; • Stockholders' equity of $30 million, $18 million MVPHS, three market makers, and operating history of two years; or • $75 million market value of listed securities or $75 million in total assets and $75 million in total revenue, $20 million MVPHS, and four market makers
Nasdaq Global Select Market	New issuers must satisfy **one** of the following requirements: • Aggregate pre-tax earnings of at least $11 million over the prior three years, with positive pre-tax earnings in each such year and at least $2.2 million of pre-tax earnings in each of the prior two years; • Aggregate cash flow of at least $27.5 million over the prior three years, with positive cash flow in each such year, an average market capitalization of at least $550 million over the prior twelve months and total revenue of at least $110 million in the previous fiscal year; or • Total revenue of at least $90 million in the previous year and an average market capitalization of at least $850 million over the prior twelve months

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<table>
<tr><th colspan="4">Fees for Listing Common Stock</th></tr>
<tr><th></th><th>Initial Listing Fees</th><th>Listing Additional Shares</th><th>Annual Fees</th></tr>
<tr><td>NYSE</td><td>• $50,000 plus $0.0032 per share, subject to a minimum of $125,000 and a maximum of $250,000
• Subject to a cap of $500,000 for total fees, including initial and annual listing fees, payable in one calendar year</td><td>• $0.0048 per share up to and including 75 additional million shares
• $0.00375 per share for more than 75 million additional shares up to and including 300 million additional shares
• $0.0019 per share for over 300 million additional shares</td><td>• The greater of $42,000 and $0.00093 per share</td></tr>
<tr><td>NYSE Arca</td><td>• $100,000 for 30 million shares or less
• $125,000 for more than 30 million shares up to and including 50 million shares
• $150,000 for more than 50 million shares
• Subject to a cap of $250,000 for total fees, including initial and annual listing fees, payable in one calendar year</td><td>• Same as NYSE</td><td>• $30,000 for up to 10 million shares
• $30,000 plus $0.000375 per share for each share above 10 million shares up to and including 100 million shares
• $85,000 for more than 100 million shares</td></tr>
<tr><td>NYSE MKT</td><td>• $50,000 for fewer than 5 million shares
• $55,000 for 5 million shares up to and including 10 million shares
• $60,000 for more than 10 million shares up to and including to 15 million shares
• $75,000 for more than 15 million shares</td><td>• $.02 per share subject to a minimum fee of $2,000 (100,000 shares or less) and a maximum fee of $45,000 (2,250,000 shares or more) per application
• The annual maximum fee for listing additional shares is $65,000</td><td>• A range from a minimum fee of $30,000 to a maximum fee of $45,000 based on the number of shares outstanding</td></tr>
</table>

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Fees for Listing Common Stock			
	Initial Listing Fees	**Listing Additional Shares**	**Annual Fees**
Nasdaq Capital Market	Application Fee: $5,000 Entry Fee: • $50,000 for up to and including 15 million shares • $75,000 for over 15 million shares	• No fee for up to 49,999 additional shares per quarter • Greater of $5,000 or $0.01 per share for 50,000 or more additional shares per quarter, subject to an annual fee cap of $65,000	• $32,000
Nasdaq Global Market and Nasdaq Global Select Market	Application Fee: $25,000 Entry Fee: • $125,000 for up to and including 30 million shares • $150,000 for greater than 30 million shares up to and including 50 million shares • $200,000 for greater than 50 million shares up to and including 100 million shares • $225,000 for over 100 million shares	• Same as Nasdaq Capital Market	• $35,000 for up to 10 million shares • $37,500 for 10 million to 50 million shares • $46,500 for 50 million to 75 million shares • $68,500 for 75 million to 100 million shares • $89,000 for 100 million to 150 million shares • $99,500 for over 150 million shares

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APPENDIX B

DETERMINING WHETHER AN ISSUER IS A PRIMA FACIE INVESTMENT COMPANY OR EXEMPT PURSUANT TO RULE 3a-1 UNDER THE INVESTMENT COMPANY ACT OF 1940

APPENDIX B

DETERMINING WHETHER AN ISSUER IS A PRIMA FACIE INVESTMENT COMPANY OR EXEMPT PURSUANT TO RULE 3A-1 UNDER THE INVESTMENT COMPANY ACT OF 1940

DEFINITIONS B-1
PRIMA FACIE INVESTMENT COMPANY B-3
RULE 3a-1 .... B-4

The Investment Company Act of 1940 ("1940 Act") regulates the business, corporate governance and securities activities of securities issuers that fall within the definition of "investment company" set forth in the 1940 Act by imposing registration, disclosure and other substantive requirements on such issuers. Any operating company contemplating a securities offering in the United States should be aware of the broad range of the definition. Furthermore, an issuer that is a holding company with minority holdings in subsidiaries may inadvertently fall within the definition of investment company and should carefully consider the factors set forth in this memorandum in analyzing the application of the 1940 Act.

An issuer is a prima facie investment company subject to regulation under the 1940 Act if it is engaged in the business of investing, reinvesting, owning, holding or trading in securities and owns or proposes to acquire investment securities having a value exceeding 40% of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

An issuer can avoid application of the 1940 Act if it is not a prima facie investment company or if it can take advantage of the exemption afforded by Rule 3a-1 under the 1940 Act. In either case, the issuer cannot be engaged or hold itself out as being engaged primarily in the business of investing, reinvesting or trading in securities.[553]

DEFINITIONS

The following definitions contained in the 1940 Act are helpful in determining whether an issuer can avoid application of the 1940 Act:

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[553] The Rule 3a-1 exemption is only available to those Issuers falling under the 1940 Act's definition of "investment company" in Section 3(a)(1)(C), but not to those covered by Sections 3(a)(1)(A) and (B). See Rule 3a-1(b).

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"**Investment securities**" means all securities except (A) Government securities, (B) securities issued by employees' securities companies and (C) securities issued by majority-owned subsidiaries of the issuer that (i) are not investment companies and (ii) are not relying on the exceptions from the definition of investment company in Sections 3(c)(1),[554] concerning beneficial ownership by not more than 100 persons, or 3(c)(7),[555] concerning ownership by qualified purchasers, of the 1940 Act.

"**Security**" is broadly defined to include, among others, any note, stock, bond, debenture, evidence of indebtedness, transferable shares, investment contract, certificate of deposits for a security, security future, among others, or, in general, any interest or instrument commonly known as a "security." For purposes of the issuer's analysis, intercompany and other loans (including time deposits with a bank), as well as many types of receivables, should be counted as securities.

"**Government security**" means any security issued or guaranteed as to principal or interest by the United States, or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit of the foregoing.[556] Thus, securities issued by other governments do not fall within this definition.

"**Majority-owned subsidiary**" of the issuer means a company 50% or more of the outstanding voting securities of which are owned by the issuer or by a company that is a majority-owned subsidiary of the issuer.

"**Value**" of assets of the issuer, as used in Section 3 of the 1940 Act, means (i) with respect to securities owned at the end of the last preceding fiscal quarter for which market quotations are readily available, the market value of such securities at the end of such quarter; (ii) with respect to other securities and assets owned at the end of the last preceding fiscal quarter, fair value at the end of such quarter as determined in good faith by the board of directors of the issuer; and (iii) with respect to securities and other assets acquired after the end of the last preceding fiscal quarter, at cost. Consequently, the 1940 Act technically requires the board of directors of an issuer wishing to establish that it is not a *prima facie* investment company or that it may meet the requirements of Rule 3a-1 to determine (*e.g.*, by

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[554] Section 3(c)(1) states that "any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and which is not making and does not presently propose to make a public offering of its securities" is not an investment company for purposes of Section 3(a)(1)(C).

[555] Section 3(c)(7) exempts "[a]ny issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities."

[556] The SEC has refused to recognize repurchase agreements involving Government securities as government securities for purposes of Rule 3a-1. See SEC No-Action Letter The Prospect Group, Inc., available Nov. 29, 1988.

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board resolution) the fair value of the issuer's total assets (other than assets consisting of securities for which market quotations are readily available). Thus, merely reviewing the most recent financial statements, while often a helpful starting point, is not sufficient. The board may, however, seek assistance from other parties in that valuation. Note: For purposes of the 1940 Act analysis, asset valuations will have to be updated to the latest practical date preceding the filing with the U.S. Securities and Exchange Commission ("SEC") of the registration statement (*e.g.*, Form S-1 or S-3) used to register the issuer's U.S. public offering, and further valuation may be necessary prior to closing the offering.

"**Wholly-owned subsidiary**" of the issuer means a company 95% or more of the outstanding voting securities of which are owned by the issuer or by a company that, within the meaning of the definition of the term, is a wholly-owned subsidiary of the issuer.

PRIMA FACIE INVESTMENT COMPANY

In order to determine whether less than 40% of the value of an issuer's assets, on an unconsolidated basis, constitute investment securities (exclusive of Government securities and cash items),[557] take the following steps:

1. Determine the value as of a recent date of the investment securities owned, on an unconsolidated basis, by the issuer.

2. Determine the value as of a recent date of the other assets (other than Government securities and cash items) owned, on an unconsolidated basis, by the issuer.

3. Divide the value of the issuer's investment securities by the aggregate value of those investment securities and the other assets (other than Government securities and cash items) owned, on an unconsolidated basis, by the issuer.

It is important to emphasize that for purposes of the above computation, the analysis is on an unconsolidated basis. Thus, it becomes necessary to analyze each subsidiary separately to determine whether or not that subsidiary is itself an investment company (or a company relying on Sections 3(c)(1) or 3(c)(7) of the 1940 Act) in order to determine whether or not the issuer's holdings in that subsidiary should be considered investment securities.

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[557] For example, cash on hand, demand (not time) deposits, checks payable in immediately available funds, cashier checks, bank drafts and letters of credit. Certificates of deposit generally would not be considered cash items. In SEC No-Action Letter, Willkie Farr & Gallagher, available Oct. 23, 2000, the SEC agreed that (subject to the terms and conditions set forth in the letter) an issuer may treat as cash items for purposes of Section 3(a)(1)(C), and Rule 3a-1 thereunder, shares of a registered investment company that holds itself out as a money market fund and seeks to maintain a stable net asset value of $1.00 per share.

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An alternative way to perform the above analysis, which is often easier because it helps to avoid uncertainties that exist in the definition of "securities," is to focus on assets that clearly are not securities (*e.g.*, inventory, property, plant and equipment) and determine whether the value of these assets exceeds 60% of the value of the issuer's total assets.

RULE 3a-1

Even if an issuer constitutes a prima facie investment company under the 1940 Act, it will not be deemed an investment company under the 1940 Act if, pursuant to Rule 3a-1, (i) no more than 45% of the aggregate value of the issuer's assets, consolidated only with the assets of any wholly-owned subsidiary (exclusive of Government securities and cash items), consists of securities other than "Good Assets" (as defined below) and (ii) no more than 45% of the issuer's net income after taxes, again consolidated only with the net income of any wholly-owned subsidiary (for the last four fiscal quarters combined) is derived from securities other than "Good Assets." (The issuer's holdings of securities of less than wholly-owned subsidiaries, and its net income derived therefrom, are examined on an unconsolidated basis.)

"**Good Assets**" means:

- Government securities;
- securities issued by employees' securities companies;
- securities issued by majority-owned subsidiaries of the issuer that are not investment companies (private or public) (other than subsidiaries relying on the Section 3(b)(3) or 3(c)(1) exclusions to avoid classification as an investment company);[558]
- securities issued by companies that (i) are controlled[559] primarily by the issuer, (ii) through which the issuer engages in a business other than that of investing,

[558] Although Rule 3a-1 has not been revised specifically to exclude securities issued by Section 3(c)(7) companies from being treated as "Good Assets," there is a significant risk that the SEC will interpret the Rule in that fashion.

[559] "Control" means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with the company.

If the issuer owns beneficially, either directly or through one or more controlled companies, more than 25% of the voting securities of a company, it is presumed to control such company unless actual management or policy control does not exist. Section 2(a)(42) of the 1940 Act defines "voting security" as "any security presently entitling the owner or holder thereof to vote for the election of directors of a company." However, the SEC has stated in a no-action letter that the Section 2(a)(42) definition of voting security "should include not only the formal legal right to vote for the election of directors pursuant to the provisions of the law . . ., but also the *de facto* power, based on all the surrounding facts and circumstances, to determine, or influence the determination of, the identity of a corporation's directors." (continued)

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reinvesting, owning, holding or trading in securities and (iii) that are not investment companies; and

- assets other than securities, such as property, buildings, inventory and equipment.

Asset Test. To determine whether an issuer passes the Asset Test of Rule 3a-1, take the following steps:

- Determine the value as of a recent date of the Good Assets of the issuer consolidated with its wholly-owned subsidiaries.
- Determine the value as of a recent date of the other assets of the issuer, consolidated with its wholly-owned subsidiaries (other than Government securities and cash items).
- Divide the value of the assets (other than the Good Assets) of the issuer, consolidated with its wholly-owned subsidiaries, by the value of the total assets of the issuer, consolidated with its wholly-owned subsidiaries (other than Government securities and cash items).
- To pass the Asset Test of Rule 3a-1, the result should be 45% or less.

Net Income After Taxes Test. To determine whether an issuer passes the Net Income After Taxes Test of Rule 3a-1, take the following steps:

- Determine the net income after taxes for the last four fiscal quarters combined derived from the Good Assets owned by the issuer and its wholly-owned subsidiaries.

See, *e.g.*, SEC No-Action Letter Philip L. Mann, available Nov. 4, 1998. Under Rule 3a-1, the issuer also must be the one primarily in control. For instance, if the issuer owns more than 25% of another company (directly or indirectly) but another beneficial owner either alone or as part of a group owns more than 25%, additional evidence of management or policy control would be required and the SEC may need to be consulted. See, *e.g.*, SEC No-Action Letter Health Communications Services, Inc., available Apr. 26, 1985.

If the issuer owns beneficially, directly or indirectly, 25% or less of the voting securities of a company, it shall be presumed not to control such company. Evidence to the contrary may rebut this presumption, but to determine control, application to the SEC should be made. See, *e.g.*, SEC No-Action Letter American Century Cos., Inc., available Dec. 23, 1997; In the Matter of Safeguard Scientifics, Inc., SEC Release Nos. 40-24317 (Feb. 25, 2000) (notice); 40-24345 (Mar. 22, 2000) (order) (granting applicant an exemption under Section 2(a)(9) of the 1940 Act and declaring that applicant controls a company despite owning less than 25% of its voting securities).

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- Determine the net income after taxes for the last four fiscal quarters combined derived from the other assets owned by the issuer, consolidated with its wholly-owned subsidiaries.

- Divide the net income after taxes for the last four fiscal quarters combined derived from such other assets by the total net income after taxes for that period derived from all the assets of the issuer, consolidated with its wholly-owned subsidiaries.[560]

- To pass the Net Income After Taxes Test of Rule 3a-1, the result should be 45% or less.

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[560] The SEC has stated in a no-action letter that a net loss for the last four quarters combined does not make the Net Income After Taxes Test irrelevant. Rather, if the issuer has both total net loss (total expenses in excess of total income) and net investment loss (investment expenses in excess of investment income), the issuer must compare its net investment loss to its total net loss to determine if investment activity accounts for more than 45% of its total net loss after taxes. Furthermore, the SEC stated that "whether the expenses are allocable to investment or operating income depends on whether the expenses are reasonably related to those activities." See SEC No-Action Letter DRX, Inc., available June 28, 1988. Difficulties in applying the Net Income After Taxes Test often make it desirable, where possible, for an issuer to rely solely on the statutory analysis of whether it is a prima facie investment company.

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APPENDIX C

DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE AND RELATED INFORMATION

APPENDIX C

DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE AND RELATED INFORMATION

GENERAL C-1
SCOPE OF APPLICATION C-2
OPERATING SEGMENTS C-3
REQUIRED DISCLOSURE C-5
ENTERPRISE-WIDE DISCLOSURE C-8

We have prepared this Appendix to assist you in understanding the operating segment and other related disclosures required by the Securities and Exchange Commission (the "SEC") in the financial statements of certain public business enterprises. These requirements are set forth in Statement of Financial Accounting Standards No. 131 ("SFAS 131"), which are published by the Financial Accounting Standards Board ("FASB"), and are applicable to filings made with the SEC in accordance with the rules and regulations of the SEC. The following is only a summary of SFAS 131 (codified in Accounting Standards Codification Topic 280, Segment Reporting), which is available on the FASB's web site at http://www.fasb.org/pdf/aop_FAS131.pdf, and the applicable rules and regulations of the SEC, which are available at http://www.sec.gov/rules.shtml.[561]

GENERAL

To help investors analyze an enterprise's financial statements and assess an enterprise's past performance and future prospects, the SEC requires certain public business enterprises to report certain financial and descriptive information about their operating segments and other related information. Operating segments are parts of an enterprise about which separate financial information is available and which the "chief operating decision maker" of the enterprise regularly evaluates in allocating resources and assessing performance. The chief operating decision maker is often the enterprise's chief executive officer or chief operating officer, but such term is used broadly to describe a business

[561] In 2012, the Financial Accounting Foundation ("FAF"; oversight body of FASB) announced that it was conducting a post-implementation review survey of SFAS 131. The survey was intended to help the FAF evaluate the effectiveness of SFAS 131, which was issued in 1997. In January 2013, the FAF reported its conclusion that SFAS 131 generally achieves its purpose, although some stakeholders suggested certain improvements. In March 2013, the FASB announced that it will review the issues raised by the FAF's post-implementation review survey with its stakeholders and the staff of the SEC to determine whether further review of the standard is warranted.

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function and not a title, and therefore may describe a group of decision makers within the enterprise.

SFAS 131 requires certain public business enterprises to report certain information about their operating segments in their annual financial statements and interim financial reports issued to shareholders about their products and services, the geographic areas in which they operate, and their major customers.

The enterprise must report the segment's profit or loss, certain specific revenue and expense items, and the assets of each segment. It must reconcile total segment revenues, total profit or loss, total assets and other segment amounts with the corresponding amounts in the enterprise's general financial statements. Additionally, the enterprise must report information about the revenues earned from products or services, the countries in which the enterprise earns revenues and holds assets, and major customers regardless of whether that information is used in making operating decisions and assessing performance. However, an enterprise is not required to report information that has not been prepared for internal use if reporting it would be considered impracticable.

An enterprise must also report certain descriptive information. It must disclose how operating segments were determined, the types of products and services each segment provides, discrepancies between the measurements used in reporting segment information and those used for the general financial statements, and changes in the measurements of segment performance from one period to another. Some commentators theorize that poor segment disclosure of public business enterprises leads investors to approach the value of segmental earnings streams cautiously, thereby discounting the market value of the overall enterprise. Better disclosure serves to reduce the degree of information asymmetry between the enterprise and the investor.

SCOPE OF APPLICATION

SFAS 131 applies to public business enterprises, which are those business enterprises that report under U.S. GAAP and (a) have issued debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), (b) are required to file financial statements with the SEC or (c) provide financial statements in connection with any issuance of a class of securities in a public market. SFAS 131 does not apply to:

(1) parent enterprises, subsidiaries, joint ventures, or investees accounted for by the equity method if their separate company statements are also consolidated or combined in a complete set of financial statements and both the separate company statements and the consolidated or combined statements are included in the same financial report; and

(2) not-for-profit organizations or non-public enterprises.

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OPERATING SEGMENTS

Definition

An operating segment is defined as a component of an enterprise:

(a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other parts of the same enterprise);

(b) whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and to evaluate its performance; and

(c) for which discrete financial information is available.

Defining segments based on the structure of an enterprise's internal organization is designed to improve information because not only would enterprises be likely to report more detailed information, but it also highlights the risks and opportunities which management considers relevant to the enterprise.

Typically, these three characteristics clearly identify a single set of operating segments for many enterprises. However, an enterprise may produce reports in which its business activities are presented in a variety of ways. If the chief operating decision maker uses more than one set of segment information, other factors may identify a single set of components as constituting an enterprise's operating segments, including the nature of the business activities of each component, the existence of managers responsible for them, and information presented to the board of directors.

Not every part of an enterprise will be an operating segment or part of one. For example, a corporate headquarters may not earn revenues or may only earn revenues that are incidental to the activities of an enterprise and, therefore, would not be an operating segment. Additionally, pension and other post-retirement benefit plans are not operating segments. An operating segment may engage in business activities for which it has not yet earned revenues (*e.g.*, start-up operations may be operating segments before earning revenues).

The method describing the reporting requirements of operating segments is referred to as the "management approach," which is based on how management organizes the segments within the enterprise for making operating decisions and assessing performance, and assists investors in seeing the enterprise through "the eyes of management." The management approach focuses on financial information that management uses to make decisions concerning the enterprise's operating matters. The components that management creates for that purpose are called operating segments. Under this approach, FASB believes financial statement preparers should be able to provide the required information in a cost-effective and timely manner.

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An enterprise must report a measure of each segment's profit or loss and certain items included in determining segment profit or loss, segment assets and certain related items. It does not require an enterprise to report segment cash flow (although it does require reporting of certain items which may provide an indication of the cash-generating ability or cash requirements of an enterprise's operating segments).

To provide comparability between enterprises, an enterprise must also disclose certain information about revenues from each of its products and services and about the countries in which it earns revenues and holds assets, regardless of how the enterprise is organized. Therefore, some enterprises may be required to disclose additional information that may not be used internally for making operating decisions and assessing performance.

Enterprise Segments Reporting Guidelines

An enterprise must report separately information about each operating segment satisfying the requirements of an operating segment identified above, although an enterprise may aggregate segments in accordance with the criteria established by SFAS 131. A segment must be reported separately if it meets any of the following quantitative criteria:

(1) its reported revenue is 10% or more of the combined revenue, derived from both internal and external sales, of all reported operating segments;

(2) its reported profit or loss is 10% or more of the greater of (a) the combined reported profit of all operating segments not reporting a loss or (b) the combined reported loss of all operating segments reporting a loss; or

(3) its assets are 10% or more of the combined assets of all operating segments.

If total external revenue by operating segments constitutes less than 75% of total consolidated revenue, additional operating segments must be identified as reporting segments even if they do not satisfy the quantitative criteria described above until the 75% threshold has been reached by reportable segments. A reporting segment that was reportable in the immediately preceding period in accordance with the quantitative criteria described above but no longer satisfies any of those criteria must still be reported as a separate segment if management judges that segment to be of continuing importance.

Information about business activities and operating segments that are not reportable must be combined and disclosed in an "all other" category separate from other reconciling items in the required reconciliations and such sources of revenue must be described.

While there is no precise limit regarding the number of reportable segments that an enterprise must separately report, if the number of reportable segments exceeds ten, a practical limit may be considered to have been reached.

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REQUIRED DISCLOSURE

General Information

An enterprise must disclose the factors used to identify the enterprise's reportable segments, including the basis of organization (*e.g.*, whether management has organized the enterprise based on differences in products and services, geographic areas or regulatory environments) and the types of products and services from which each reportable segment derives its revenues.

Information about Profit or Loss, Assets and the Basis of Measurement

Information about Profit or Loss. An enterprise must report a measure of profit or loss and total assets for each reportable segment. An enterprise must also disclose the following information for each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker or are regularly provided to the chief operating decision maker, even if not so included:

(1) revenues from external customers;

(2) revenues from transactions with other operating segments of the same enterprise;

(3) interest revenue;

(4) interest expense;

(5) depreciation, depletion and amortization expense;

(6) certain unusual items;

(7) equity in the net income of investees accounted for by the equity method;

(8) income tax expense or benefit;

(9) extraordinary items; and

(10) significant non-cash items other than depreciation, depletion and amortization expense.

Interest revenue for each reportable segment must be reported separately from interest expense unless a majority of the segment's revenues represent interest and the chief operating decision maker relies primarily on net interest revenue to assess performance of the segment and make allocation decisions. In such case, an enterprise may report the segment's interest revenue net of its interest expense and disclose that it has done so.

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Information about Assets. An enterprise must disclose the following information for each reportable segment if the specified amounts are included in the determination of segment assets reviewed by the chief operating decision maker or are regularly provided to the chief operating decision maker, even if not so included:

(1) the amount of investment in equity method investees; and

(2) total expenditures for additions to long-lived assets other than financial instruments, long-term customer relationships of a financial institution, mortgage and other servicing rights, deferred policy acquisition costs and deferred tax assets.

Measurement. The amount of each item within a reported segment shall be the measure reported to the chief operating decision maker for purposes of making decisions about allocating resources to such segment and assessing its performance. Adjustments, eliminations and allocations made in preparing financial statements need not be included unless they are included in the measure of the segment's profit or loss that is used by the chief operating decision maker. Similarly, only the assets included in the measure of the segment's assets that is used by the chief operating decision maker need to be reported for that segment.

If the chief operating decision maker uses only one measure of profit or loss and assets in assessing performance and deciding resource allocation, profit or loss and assets shall be reported as those measures. If more than one method is used, then the measures that management believes are most consistent with those used in measuring the corresponding amounts in the enterprise's consolidated financial statements should be reported.

In explaining the measurements of profit or loss and assets for a segment, an enterprise must disclose at a minimum:

(1) the basis of accounting for any transactions between reportable segments;

(2) the nature of any differences between measurements of the reportable segments, profit or loss and the enterprise's consolidated income before income taxes, extraordinary items and discontinued operations;

(3) the nature of any differences between measurements of the reportable segments, assets and the enterprise's consolidated assets;

(4) the nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of profit or loss; and

(5) the nature and effect of any asymmetrical allocations to segments (*e.g.*, an enterprise may allocate depreciation expense to a segment without allocating the corresponding depreciable assets to that segment).

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Reconciliations of Segment Revenues, Reported Profit or Loss, Assets and Other Significant Items to the Corresponding Enterprise Amounts

An enterprise must provide reconciliations of the following:

(1) the total of the revenues of the reportable segments to the consolidated revenues of the enterprise;

(2) the total of the measures of profit or loss of the reportable segments to the consolidated income before income taxes, extraordinary items and discontinued operations of the enterprise;

(3) the total of the assets of the reportable segments to the consolidated assets of the enterprise; and

(4) the total of amounts of other information disclosed of the reportable segments to the corresponding consolidated amount (*e.g.*, if liabilities for each reportable segment are disclosed, then the enterprise must reconcile the total liabilities for all reportable segments to the consolidated liabilities of the enterprise if the segment liabilities are significant).

All significant reconciling items must be separately identified and described. For example, the amount of each significant adjustment to reconcile accounting methods used in determining segment profit or loss to the enterprise's consolidated amounts must be separately identified and described.

Interim Period Information

Financial statements for interim periods issued to investors must include the following disclosure relating to each of its segments:

(1) revenues from external customers;

(2) intersegment revenues;

(3) a measure of segment profit or loss;

(4) total assets for which there has been a material change from the last annual report;

(5) a description of differences from the last annual report in the basis of segmentation or measurement of segment profit or loss; and

(6) a reconciliation of the total of the measure of profit or loss of the segments to consolidated income before income taxes, extraordinary items and discontinued operations (unless the enterprise allocated items such as income taxes and extraordinary items to segments, in which case the enterprise may

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reconcile the total of the segments' measures of profit or loss to consolidated income after those items).

Restatement of Previously Reported Information

If an enterprise changes the structure of its internal organization so that it changes the composition of its reportable segments, there must be a restatement of the corresponding information unless to do so would be impracticable. Following a change in the composition of its reportable segments, an enterprise must disclose whether it has restated the corresponding items of segment information for earlier periods. If there is not a restatement to reflect the change, the enterprise shall disclose in the year in which the change occurs segment information for the current period under both the old basis and the new basis of segmentation unless to do so would be impracticable.

ENTERPRISE-WIDE DISCLOSURE

The following descriptive information is required to be disclosed by an enterprise if it is not provided in accordance with the other provisions of SFAS 131.

Information about Products and Services

An enterprise must report the revenues from external customers for each product and service or each group of products and services unless to do so would be impracticable. The amounts of revenues reported shall be based on the financial information used to produce the general-purpose financial statements. If providing such information is impracticable, that fact must be disclosed.

Information about Geographic Areas

Unless impracticable, an enterprise must report:

(1) revenues from external customers that are: (a) attributed to the enterprise's country of domicile and (b) attributed to all foreign countries in total from which the enterprise derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues are required to be disclosed separately; and

(2) long-lived assets other than financial instruments, long-term customer relationships of a financial institution, mortgage and other servicing rights, deferred policy acquisition costs, and deferred tax assets that are (a) located in the country of domicile and (b) located in all foreign countries in total where the enterprise holds assets. If assets in any individual foreign country are material, those assets are required to be disclosed separately.

If providing geographic information is impracticable, that fact must be disclosed. An enterprise may choose to allocate revenues from external customers in any reasonable, consistently applied and disclosed manner. With this flexibility, enterprises may report

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geographic revenue information by selling location, customer location or the location to which the product is delivered.

Information about Major Customers

An enterprise must provide information about the extent to which it relies on its major customers. If revenues from transactions with a single external customer amount to 10% or more of total revenues, the enterprise must disclose that fact, the total amount of revenues received from that customer and the identity of the segment or segments reporting such revenues. However, the identity of the customer or the amount of revenues each segment reports from such customer need not be reported.

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APPENDIX D

SUMMARY OF SEC RELEASES ON MD&A

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SUMMARY OF SEC RELEASES ON MD&A

THE JANUARY 2002 RELEASE D-1
THE DECEMBER 2001 AND MAY 2002 RELEASES (CRITICAL ACCOUNTING POLICIES) D-6
THE JANUARY 2003 RELEASE D-8
THE DECEMBER 2003 RELEASE....................D-11
MD&A DISCLOSURE ON FAIR VALUE....................D-17
THE FEBRUARY 2010 RELEASE (CLIMATE CHANGE) D-21
THE SEPTEMBER 2010 INTERPRETIVE RELEASE AND PROPOSED RULE D-22
THE OCTOBER 2011 RELEASE (CYBERSECURITY)....................D-25
DIVISION OF CORPORATION FINANCE: DISCLOSURE GUIDANCE D-26

Since December 2001, the Securities and Exchange Commission (the "SEC") has taken a series of actions regarding the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") section of companies' disclosure documents. For U.S. issuers, MD&A disclosure is required to be included in Form 10-K, Form 10-Q and Form S-1, is incorporated by reference into Form S-3 and is either included or, where permitted, incorporated by reference into Form S-4. A summary of the relevant releases follows.

THE JANUARY 2002 RELEASE

On January 22, 2002, the SEC issued a statement setting forth its views regarding additional disclosure that public companies should consider in the preparation of their MD&A.[562]

The SEC issued the statement in response to a petition from the former Big Five accounting firms for additional guidance in preparing annual reports as a result of events that have raised questions about the integrity and sufficiency of financial and accounting disclosures.[563]

The SEC's statement elaborated its views on the requirements of MD&A as they relate to:

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[562] The SEC's statement (SEC Release No. 33-8056 (Jan. 22, 2002) (http://www.sec.gov/news/headlines/discreqsjan22.htm)).

[563] A copy of the petition can be found at http://www.sec.gov/rules/petitions/petndiscl-12312001.htm.

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- liquidity and capital resources, including off-balance sheet arrangements;
- trading activities in certain types of commodity contracts (non-exchange traded contracts accounted for at fair value); and
- related party transactions and other transactions or relationships that are not on an arm's-length basis.

The SEC believes that the quality of information provided in these three areas should be improved and suggests specific steps that companies should consider in meeting their disclosure obligations. At the same time, the SEC said that its statement does not create new legal requirements or modify existing requirements.

The statement reminds companies that a "basic and overriding" requirement of MD&A is to "provide such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations" with particular emphasis on prospects for the future. The statement also reiterates the requirement that companies disclose any known trends or uncertainties that are "reasonably likely" to have a material effect on their financial condition or results of operations. The SEC contends that this disclosure threshold is lower than "more likely than not." Considering these general principles, the statement proceeds to provide a more detailed description of the types of disclosure that companies should consider in the three identified categories.

Liquidity and Capital Resources, Including Off-Balance Sheet Arrangements

The statement indicates that disclosures with respect to liquidity, capital resources and off-balance sheet arrangements are interrelated and should be considered together, as well as individually, when drafting MD&A.

Liquidity and Capital Resources. The statement reminds companies of their obligations to identify and discuss trends and any known demands, commitments, events or uncertainties relating to liquidity, such as operating cash flows or commercial paper, and capital resources. These may include equity, debt and any off-balance sheet financing arrangements. The disclosures might include discussions of material risks relating to liquidity and capital resources, such as the effects of changes in customer demand for the company's products, rapid technological changes, a debt rating downgrade or deterioration in certain of the company's financial ratios or other measures of financial performance. If liquidity or capital resources are dependent on the use of off-balance sheet financing arrangements, the company should consider disclosure of the factors that are reasonably likely to affect its ability to continue using those off-balance sheet financing arrangements.

The statement lists several examples of items that should be considered in order to help identify trends, demands, commitments, events and uncertainties that require disclosure. These include:

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- provisions in agreements that may trigger an adverse financial requirement, such as the acceleration of debt;
- circumstances that could impair the company's historical manner of doing business, such as a credit rating downgrade;
- factors that are relevant to the company's credit rating and ability to raise financing;
- guarantees and commitments; and
- options on non-financial assets.

The SEC advised against disclosures that are excessively general, boilerplate or merely statements of a conclusion, such as a statement that a company has sufficient short-term funding sources. Instead, the SEC said, the disclosures should explain the circumstances and the basis for each statement in sufficient detail to permit an investor to understand the material facts and be able to reach his or her own conclusion.

Off-Balance Sheet Arrangements. The SEC stated that off-balance sheet arrangements should be disclosed if they are reasonably likely to have a material effect on liquidity or the availability of or requirements for capital resources. It may also be necessary to describe the extent of a company's reliance on such arrangements and their relative significance to the company's financial position. For instance, disclosure may need to be provided about arrangements using special-purpose entities that:

- provide financing, liquidity or market or credit risk support for the company;
- engage in leasing, hedging, research and development services with the company; or
- expose the company to liability that is not reflected on the face of the financial statements.

Disclosure of uncertainties and their effects should also be provided where contingencies inherent in the arrangements are reasonably likely to affect the continued availability of material historical sources of liquidity and financing. Disclosure of the effects and risks of off-balance sheet arrangements may be required even if the company has obtained a "true sale" legal opinion or otherwise complied with technical requirements to keep such arrangements off the balance sheet or to limit recourse to the company, although such matters may affect the type of disclosure and the risks involved.

In the SEC's view, information regarding exposures arising from off-balance sheet arrangements should be included if necessary in order to provide investors with a clear understanding of the company's business activities, financial arrangements and financial

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statements. The statement lists examples of additional disclosures that should be considered to explain the effects and risks of off-balance sheet arrangements. These include:

- the amount and description of the assets and obligations of the off-balance sheet entity;
- the possible termination of the entity or its arrangements with the company;
- the amount of receivables, payables, revenues, expenses and cash flows resulting from the arrangements;
- payment terms of amounts due to the company from the arrangements and any uncertainties or contingencies as to realization;
- the amounts and key terms and conditions of agreements; and
- the amounts and descriptions of any guarantees, lines of credit, standby letters of credit, commitments or other similar types of arrangements.

Contractual Obligations and Commercial Commitments. Although accounting standards require disclosure concerning a company's obligations and commitments to make future payments under contracts and other contingent commitments, the statement suggests that all such information should be described in one location in MD&A. The statement includes examples of charts or schedules that could be included in MD&A to present a total picture of a company's liquidity, capital resources, contractual obligations and commitments as of the latest balance sheet date. The examples of charts and schedules also include columns that could be used to show the amounts of contractual obligations that become due and commitments that expire in future periods. The charts and schedules could be accompanied by a description of provisions that create, increase or accelerate liabilities or other data that may be helpful to a full understanding of the company's obligations and commitments.

Non-Exchange Traded Contracts Accounted for at Fair Value

The SEC said that it is concerned that there may be a lack of transparency and clarity with respect to companies engaged to a material extent in energy trading activities, weather trading activities or non-exchange traded commodity trading contracts that are marked to fair value. In contrast to exchange traded commodity contracts that have a publicly-available market price, a lack of market price quotations for such contracts necessitates the use of fair value estimation techniques. These contracts may be indexed to measures of weather, commodities prices or quoted prices of service capacity, such as energy storage and bandwidth capacity contracts.

Companies engaged to a material extent in trading activities involving such types of contracts should consider disclosing in their MD&A how the activities affect reported results for the most recent reporting period(s) and how the company's financial position is affected

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as of the latest balance sheet date. This might include a discussion of material trends and uncertainties arising from these trading activities and may include information about the activities themselves, contracts and modeling methodologies, assumptions, variables and inputs, and an explanation of the different outcomes reasonably likely under different circumstances or measurement methods. Disclosures regarding trading activities might also address any derivative contracts involving the same commodities.

The statement refers to cautionary advice issued by the SEC[564] encouraging companies to include in their MD&A full explanations, in plain English, of their "critical accounting policies," the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. Consistent with that advice, the SEC suggested that companies should consider furnishing the following qualitative and quantitative information with respect to non-exchange traded contracts:

- disaggregated realized and unrealized changes in fair value;
- changes in fair value attributable to changes in valuation techniques;
- disaggregated estimated fair values at the latest balance sheet date; and
- maturities of contracts at the latest balance sheet date.

The statement provides an example of this disclosure in the form of a schedule that could be included in MD&A.

Companies should also consider their disclosure obligations regarding risk management in connection with the trading activities. For example, companies may consider discussing the risks of changes in credit quality or market fluctuations of underlying, linked or indexed assets or liabilities, especially where such assets are illiquid or susceptible to material uncertainties in valuation. In addition, companies should consider the need to disclose the fair value of net claims against counterparties that are reported as assets at the most recent balance sheet date, based on the credit quality of the contract counterparty (*e.g.*, investment grade, non-investment grade or no external ratings).

Related Party and Similar Transactions

The statement indicates that MD&A should include a discussion of material related party transactions to the extent necessary for an understanding of the company's current and prospective financial position and operating results. Discussion of the following may be necessary:

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[564] SEC Release Nos. 33-8040, 34-45149, FR-60 (Dec. 12, 2001).

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- business purpose;
- identification of the related parties;
- how transaction prices were determined;
- whether and how the transaction has been evaluated for fairness; and
- any ongoing contractual or other commitments resulting from the arrangement.

The discussion may also include a description of the elements of the transaction, its economic substance, any special risks or contingencies and its effect on the financial statements.

In addition, the statement appears to go beyond previous guidance given by the SEC as to the appropriate disclosure with respect to related party transactions. The statement says that companies should consider whether it is necessary to disclose transactions involving a relationship that enables the parties to negotiate terms of material transactions that may not be available from clearly independent third parties on an arm's-length basis, even if the transaction is not with parties that fit within the definition of "related parties." The statement indicates that this disclosure is necessary if investors would be unable to understand a company's reported results of operations without a clear explanation of these arrangements and relationships.

The SEC's release is an important indication of its heightened sensitivities in the area of accounting and financial disclosure in light of recent events. Companies should carefully consider the suggestions and guidance of the SEC and recognize the possibility that their annual and other periodic reports may be reviewed with these issues in mind.

THE DECEMBER 2001 AND MAY 2002 RELEASES (CRITICAL ACCOUNTING POLICIES)

On December 12, 2001, the SEC issued cautionary advice regarding disclosure about critical accounting policies.[565] In the December 2001 advice, the SEC said that it intended to consider new rules during 2002 (see the discussion of the May 2002 proposal below) to elicit more precise disclosures about the accounting policies that management believes are the most "critical" – "that is, they are both most important to the portrayal of the company's financial condition and results, and they require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain." The SEC encouraged companies to include their critical accounting policies in the MD&A.

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[565] *Supra* note 564.

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The SEC also emphasized the importance of employing a disclosure regime along the following lines:

- each company's management and auditor should bring particular focus to the evaluation of critical accounting policies used in the financial statements;

- management should ensure that disclosure in MD&A is balanced and fully responsive;

- prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies; and

- if companies, management, audit committees or auditors are uncertain about the application of specific GAAP principles, they should consult with the SEC's accounting staff.

On May 10, 2002, the SEC proposed rules to mandate additional disclosure in public company filings. The proposal would require almost all public companies to expand the MD&A to include complex and detailed narrative disclosure to explain the application and, in some cases, the adoption of critical accounting policies.[566] While the SEC has taken no further action of the proposal, it remains instructive of the views of the SEC staff. The May 2002 proposal includes hypothetical examples illustrating the application of the proposed rules.

With very limited exceptions, the May 2002 MD&A proposal would require that public companies' periodic reports on Form 10-K and Form 10-Q include within a separate section of the MD&A explanations of their "critical accounting estimates." The same presentation would be required in long-form registration statements under both the 1933 Act and the 1934 Act.

In general terms, a "critical accounting estimate" is an accounting estimate that requires management to exercise judgment in the determination of an amount that would have a material effect on the company's financial condition. Approximation in these determinations is appropriate under the accounting regulations as a practical necessity because the amount in question may be affected by future events that are not currently certain.

The May 2002 proposal is related thematically to the January 2002 release. In that statement, the SEC recommended that public companies "should consider" its suggestions for MD&A disclosures of off-balance sheet financing arrangements and over-the-counter derivative contracts. The SEC's recommendations included the use of elaborate tabular presentations.

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[566] SEC Release Nos. 33-8098, 34-45907 (May 10, 2002) (http://www.sec.gov/rules/proposed/33-8098.htm).

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The SEC, which calls its proposal "an initial step in improving the transparency of companies' financial disclosure," believes that the added narratives will improve investors' understanding of financial statement disclosures.

THE JANUARY 2003 RELEASE

On January 28, 2003, the SEC adopted rules required in part by Section 401(a) of the Sarbanes-Oxley Act. Section 401(a) added provisions to the 1934 Act, including Section 13(j), which directed the SEC to adopt rules requiring disclosure of off-balance sheet arrangements in each annual and quarterly report. On its own motion, the SEC adopted additional tabular disclosure requirements for aggregate contractual obligations.

The complex disclosures, which are detailed in Item 303 of Regulation S-K, must be presented in the MD&A. The requirements for off-balance sheet arrangements affect all reporting companies except registered investment companies.

It is worth noting that the SEC regards these rules at least in part to be only explicit codifications of existing MD&A requirements, at least as they are construed by the SEC and its staff.[567]

Off-Balance Sheet Arrangements

Definitions

Section 13(j) of the 1934 Act calls for disclosure of "all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the company with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses." Item 303 of Regulation S-K defines an "off-balance sheet arrangements" as:

- any obligation under a guarantee contract that has any of the characteristics identified in FASB ASC paragraph 460–10–15–4 (Guarantees Topic), as may be modified or supplemented, and that is not excluded from the initial recognition and measurement provisions of FASB ASC paragraphs 460–10–15–7, 460–10–25–1, and 460–10–30–1;

- a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to such entity for such assets;

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[567] SEC Release No. 33-8182 (Jan. 28, 2003) (http://www.sec.gov/rules/final/33-8182.htm).

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- any obligation, including a contingent obligation, under a contract that would be accounted for as a derivative instrument, except that it is both indexed to the company's own stock and classified in stockholders' equity in the company's statement of financial position, and therefore excluded from the scope of FASB ASC Topic 815, Derivatives and Hedging, pursuant to FASB ASC subparagraph 815–10–15–74(a), as may be modified or supplemented; or

- any obligation, including a contingent obligation, arising out of a variable interest (as defined in the FASB ASC Master Glossary), as may be modified or supplemented) in an unconsolidated entity that is held by, and material to, the company, where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the company.

The SEC believes that the definition will not cause disclosure of "routine transactions" such as employment agreements, leases, licenses, and employee pension plans. Off-balance sheet arrangements do not include contingent liabilities related to litigation, arbitration or regulatory actions. Instructions to the item provide that no disclosure will be required before there is an unconditionally binding agreement or agreement subject only to customary closing conditions or, in the absence of an agreement, on settlement of the arrangement. To satisfy the disclosure requirements, companies need not repeat in the MD&A information included in the financial statement footnotes if clear cross-references are provided and if the MD&A integrates the information in question into the discussion. Off-balance sheet arrangements may include arrangements in which the company is not party to the agreement representing the primary obligation. In the SEC's view, the definition will focus on off-balance sheet arrangements used for financing, liquidity or risk-sharing purposes.

Disclosure Threshold

1934 Act Section 13(j) refers to off-balance sheet arrangements "that may have a material current or future effect" on a company. In the rules, the standard of probability for disclosure of an off-balance sheet arrangement is whether such an effect is "reasonably likely," which is the same standard used for MD&A disclosure generally. It is important to note, however, the SEC's view that "'reasonably likely' is a lower disclosure threshold than 'more likely than not.'"

Required Disclosures

The rules require off-balance sheet arrangements to be disclosed in a separately captioned section of MD&A. Any off-balance sheet arrangement as defined by the SEC with effects material to investors on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources is subject to the disclosure requirement. "To the extent necessary to an understanding of such arrangements," the disclosures must include statements of:

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- the nature and business purpose of the arrangements;

- the importance of the arrangements for the company's liquidity, capital resources, market risk support, credit risk support or other unspecified benefits;

- amounts of revenues, expenses and cash flow related to the arrangements, the nature and amount of any retained interests, securities issuances or debt incurrences related to the arrangements, and the nature and amounts of any other obligations or liabilities with reasonably likely material effects (including an explanation how such obligations or liabilities could be triggered); and

- known events, demands, commitments, trends or uncertainties that will or are reasonably likely to result in the termination or material reduction of off-balance sheet arrangements with material benefits and of the course of action the company has taken or proposes to take in the event of such a termination or reduction.

Filings Affected

Annual Reports on Form 10-K and Quarterly Reports on Form 10-Q are required to include the MD&A disclosures on off-balance sheet arrangements. 1933 Act registration statements, including those requiring interim period information and related MD&A disclosure, but not including the MJDS forms, are subject to the off-balance sheet disclosure requirements, although issuers entitled to do so by the applicable "S" form may incorporate that information by reference.

Contractual Obligations

Definition

As with off-balance sheet arrangements, the SEC has defined the four categories of disclosable contractual obligations largely in reference to accounting authorities. These are:

- long-term debt obligations—payment obligations described in FAS No. 47, *Disclosure of Long-Term Obligations* (March 1981);

- capital lease obligations—payment obligations classified as capital leases in FAS No. 13, *Accounting for Leases* (November 1976);

- operating lease obligations—payment obligations classified as operating leases within the same FAS; and

- purchase obligations—binding agreements to purchase goods or services with specific terms for purchase fixed or minimum quantities at fixed, minimum or variable prices and for approximate timing of performance, which are not recognized as liabilities under GAAP, but which have been included because the SEC believes they may have a "significant effect" on liquidity.

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Required Disclosures

Each Annual Report on Form 10-K and Quarterly Report on Form 10-Q must include a table showing each of the four categories of contractual obligations as of the end of the most recent fiscal year or quarter, as the case may be, and showing the amounts due under the obligations as a total and by periods: less than one year, one to three years, three to five years, and more than five years. The table must be presented under a separate caption within the MD&A.

Liability Matters

Acting under Section 27A of the 1933 Act and Section 21E of the 1934 Act, the SEC included in the new rules liability protections for any forward-looking statement made pursuant to the disclosure requirements applicable to off-balance sheet arrangements and contractual obligations. The requirement of the statutory safe harbors for "meaningful cautionary statements" will be deemed to have been satisfied for MD&A disclosures of off-balance sheet arrangements through compliance with the rules. This does not apply, however, to the table of contractual obligations.

THE DECEMBER 2003 RELEASE

On December 19, 2003, the SEC provided further advice on MD&A for the purpose of assisting companies in preparing MD&A disclosure that is easier to follow and understand and providing more information regarding the SEC's previously enunciated principal objectives of MD&A.[568] In the December 2003 advice, the SEC stated that "MD&A should not be a recitation of financial statements in narrative form or an otherwise uninformative series of technical responses to MD&A requirements," neither of which provides management's "unique perspective on its business …." The SEC also encouraged early top-level involvement by a company's management in identifying key disclosure themes and items to be included in the MD&A.

Presentation of MD&A

The SEC emphasized the following points regarding overall presentation in the MD&A:

- within the universe of material information, present disclosure so that the most important information is the most prominent;
- avoid unnecessary duplicative disclosure; and
- start the MD&A with an executive-level overview that provides context.

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[568] SEC Release No. 33-8350 (Dec. 19, 2003) (http://www.sec.gov/rules/interp/33-8350.htm).

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While noting that "complex companies and situations require disclosure of complex matters" and that the SEC is "not in any way seeking over-simplification or 'dumbing down' of MD&A," it emphasized the need for improving the clarity and understandability of MD&A by using language that is clearer and less convoluted. The SEC recommended considering the use of tabular presentations, headings, introductory sections or overviews and the use of a "layered approach," whereby material information and analysis that it the most important would be emphasized. An introductory overview would

- include economic or industry-wide factors relevant to the company;
- discuss how the company earns revenues and income and generates cash;
- to the extent necessary or useful, discuss lines of business, locations or locations of operations and principal products and services (but not merely duplicating the disclosure on the "Description of Business" section); and
- provide insight into material opportunities, challenges and risks, such as those presented by known material trends and uncertainties, upon which the company's executives at most focused for the short and long-term, and the actions they are taking to address these opportunities, challenges and risks.

Content and Focus of MD&A

The SEC emphasized the following points regarding content and focus of MD&A:

- focus on material information and de-emphasize or eliminate immaterial information;
- identify and discuss key performance indicators, including non-financial performance indicators;
- identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance; and
- provide an analysis explaining management's view of the implications and significance of the information provided in response to the MD&A requirements.

Focus on Materiality

The SEC emphasized that MD&A most specifically focus on known material events and uncertainties that would cause reported financial information not to be necessarily indicative of future operating performance or future financial conditions. The SEC noted that segment data should be provided where it is material to an understanding of the consolidated financial information. Segment discussion should be designed to avoid unnecessary

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duplication and immaterial detail. The SEC also warned against excessive disclosure of line item changes where such disclosure is not material.

Key Performance Indicators

The SEC noted that if companies include in their MD&A material information disclosed other than in their filed documents (such as in earnings releases or publicly-accessible analysts' calls or companion web site postings), they should evaluate whether that information is responsive to the MD&A requirements and whether its omission would render misleading the document in which the MD&A appears.

Focus on Material Trends and Uncertainties

With respect to material trends, demands, commitments, events and uncertainties, the SEC stated that such disclosure generally should involve

- the consideration of financial, operational and other information known to the company;
- the identification, based on this information, of known trends and uncertainties; and
- an assessment of whether these trends and uncertainties will have, or are reasonably likely to have, a material impact on the company's liquidity, capital resources or results of operations.

Disclosure of a trend, demand, commitment, event or uncertainty is required unless a company is able to conclude either that it is not reasonably likely that the trend, uncertainty or other event will occur or come to fruition, or that a material effect on the company's liquidity, capital resources or results of operations is not reasonably likely to occur.

Focus on Analysis

The SEC stressed the importance of including an analysis when a description of known material trends, events, demands, commitments and uncertainties is set forth. That analysis should explain the underlying reasons or implications, interrelationships between constituent elements, or the relative significance of those matters. A thorough analysis often will involve discussing both the intermediate effects of those matters and the reasons underlying those intermediate effects. The SEC provided the following example:

> For example, if a company's financial statements reflect materially lower revenues resulting from a decline in the volume of products sold when compared to a prior period, MD&A should not only identify the decline in sales volume, but also should analyze the reasons underlying the decline in sales when the reasons are also material and determinable. The analysis should reveal underlying material causes of the matters described, including for example, if applicable, difficulties in the

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manufacturing process, a decline in the quality of a product, loss in competitive position and market share, or a combination of conditions.

The SEC also warned that "if there is a reasonable likelihood that reported financial information is not indicative of a company's future financial condition or future operating performance due, for example, to the levels of subjectivity and judgment necessary to account for highly uncertain matters and the susceptibility of such matters to change, appropriate disclosure in the MD&A should be considered and may be required."

Liquidity & Capital Resources

With respect to MD&A disclosure regarding liquidity and capital resources, the SEC recommended that:

- companies should consider enhanced analysis and explanation of the sources and uses of cash and material changes in particular items underlying the major captions reported in their financial statements;

- companies using the indirect method in preparing cash flow statements should pay particular attention to disclosure and analysis of matters not readily apparent from the face of their cash flow statements; and

- companies consider enhanced MD&A disclosure regarding debt instruments, guarantees and related covenants.

The SEC also advised that companies should evaluate separately their ability to meet upcoming cash requirements over both the long and short term. The discussion of disclosure regarding liquidity and capital resources covered four areas:

- cash requirements;

- sources and uses of cash;

- debt instruments, guarantees and related covenants; and

- cash management.

Cash Requirements

The SEC recommended that companies consider whether the following information would have a material impact on liquidity:

- funds necessary to maintain current operations, complete projects underway and achieve stated objective or plans;

- commitments for capital and other expenditures; and

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- the reasonably likely exposure to future cash requirements associated with known trends or uncertainties, and an indication of the time period in which resolution of the uncertainties is anticipated.

The SEC suggested the use of tabular disclosure of contractual requirements, where helpful. The SEC advised that companies should address, where material, the difficulties involved in assessing the effect of the amount and timing of certain events, such as loss contingencies, on cash requirements and liquidity.

Sources and Uses of Cash

Disclosure of this factor should not only explain how the particular cash requirements fit into a company's overall business plan, but should also focus on the resources available to satisfy those cash requirements. If there has been material variability in historical cash flows, the disclosure should focus on the underlying reasons for those changes as well as their reasonably likely impact on future cash flows and management decisions.

The SEC also emphasized disclosure regarding material changes in operating, investing and financing cash flows and the reasons underlying those changes.

The SEC advised that the discussion and analysis of operating cash flows should address material changes in the underlying drivers, rather than merely describing items identified on the face of the statement of cash flows, such as the reconciling items used in the indirect method of presenting cash flows. Companies should also consider whether, in order to make the required disclosures, it is necessary to expand the MD&A to address the cash requirements of and the cash provided by its reportable segments or other subdivisions of the business, including issues related to foreign subsidiaries, as well as the indicative nature of those results. Companies should also discuss the effect of an inability to access the cash flow and financial assets of any consolidated entities.

A discussion of historical financing arrangements and their importance to cash flows should include an analysis of a company's

- external debt financing;
- off-balance sheet financing arrangements;
- issuances and purchases of derivative instruments linked to the company's stock;
- use of its stock as a form of liquidity; and
- the potential impact of known or reasonably likely changes in credit ratings or ratings outlook (or inability to achieve changes).

Consideration should be given to disclosure regarding prospective financing sources, or of types of financing sources that a company would want to use but that are, or are

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reasonably likely to be, unavailable, and the impact on the company's cash position and liquidity. Such disclosure should be considered if a company will, or if it is reasonably likely that it will, raise material external equity or debt financing, and should include the amounts or ranges involved, the nature and terms of the financing and other material terms, as well as the impact on the company's cash position and liquidity.[569]

Debt Instruments, Guarantees and Related Covenants

The SEC noted two situations in which a discussion and analysis of material covenants related to a company's outstanding debt may be required in MD&A.

If a company is in breach, or reasonably likely to be in breach, of a material covenant, the company must disclose and analyze, as applicable:

- the steps that the company is taking to avoid the breach;
- the steps that the company intends to take to cure, obtain a waiver of or otherwise address the breach;
- the impact or reasonably likely impact of the breach (including the effects of any cross-default or cross-acceleration or similar provisions) on financial condition or operating performance; and
- alternate sources of funding to pay off resulting obligations or replace funding.

If covenants in a company's outstanding debt limit, or are reasonably likely to limit, the company's ability to undertake financing to a material extent, the company is required to discuss the covenants in question and the consequences of the limitation to the company's financial condition and operating performance.

Cash Management

The SEC noted that a company should describe how known material trends or uncertainties affect the company's determination as to when and how to use its cash resources to satisfy obligations and make other capital expenditures.

Critical Accounting Estimates

With respect to MD&A disclosure of critical accounting estimates, the SEC recommended that companies consider enhanced discussion and analysis that supplements, but does not duplicate, the description of accounting policies in the notes to the financial

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[569] With respect to disclosure about possible future financing, the SEC stated that "we believe that disclosure satisfying the requirements of MD&A can be made consistently with the restrictions of Section 5 of the 1933 Act. See, *e.g.*, 1933 Act Rule 135c."

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statements and provides greater insight into the quality and variability of information regarding financial condition and operating performance.

When preparing disclosure under the current SEC requirements, companies should consider whether they have made accounting estimates or assumptions where:

- the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and
- the impact of the estimates and assumptions on financial condition or operating performance is material.

The MD&A discussion should present a company's analysis of the uncertainties involved in applying a principle at the given time or the variability that is reasonably likely to result from its application over time. The company should also address specifically why its accounting estimates or assumptions bear the risk of change.

MD&A DISCLOSURE ON FAIR VALUE

In late 2007 and early 2008, and in response to the subprime crisis, the SEC staff reviewed issuers' MD&A and commented on whether exposure to subprime securities or other higher risk loans has been adequately disclosed. The SEC staff's review focused on issuers that are significantly affected by the impairment of securities and the liquidation of collateralized debt obligations.[570] In March 2008, the SEC staff commented on the application of SFAS 157 on fair value measurements.[571]

In March and February of 2008, the Division of Corporate Finance of the SEC sent letters to the chief financial officers of certain public companies identifying a number of disclosure issues relating to SFAS 157 that companies may wish to consider in preparing their MD&A.[572] In particular, the SEC noted that, if a company concludes that its use of unobservable inputs is material, the company should disclose, in a manner most useful to the company's particular facts and circumstances, how the company determined them and how the resulting fair value of the company's assets and liabilities and possible changes to those values, impacted or could impact the company's results of operations, liquidity, and capital

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[570] See CCH SEC Today, January 2, 2008, Volume 2008-1, discussing the remarks of SEC Associate Chief Accountant Stephanie Hunsaker.

[571] Comments by Brian Breheny, Deputy Director, SEC Division of Corporation Finance, at the ABA Committee on Federal Regulation of Securities, April 11, 2008.

[572] Sample Letters Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements), dated March 2008 (http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm) and September 2008 (http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm).

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resources. The SEC noted that the following disclosure and discussion points may be relevant to a company preparing its MD&A:

- The amount of assets and liabilities the company measured using significant unobservable inputs (Level 3 assets and liabilities) as a percentage of the total assets and liabilities the company measured at fair value.

- The amount and reason for any material increase or decrease in Level 3 assets and liabilities resulting from the company's transfer of assets and liabilities from, or into, Level 1 or Level 2.

- If the company transferred a material amount of assets or liabilities into Level 3 during the period, a discussion of:

  - the significant inputs that the company no longer consider to be observable; and

  - any material gain or loss the company recognized on those assets or liabilities during the period, and, to the extent the company excludes that amount from the realized/unrealized gains (losses) line item in the Level 3 reconciliation, the amount the company excluded.

- With regard to Level 3 assets or liabilities, a discussion of, to the extent material:

  - whether realized and unrealized gains (losses) affected the company's results of operations, liquidity or capital resources during the period, and if so, how;

  - the reason for any material decline or increase in the fair values; and

  - whether the company believes the fair values diverge materially from the amounts the company currently anticipates realizing on settlement or maturity. If so, disclose why and provide the basis for the company's views.

- The nature and type of assets underlying any asset-backed securities, for example, the types of loans (sub-prime, Alt-A, or home equity lines of credit) and the years of issuance as well as information about the credit ratings of the securities, including changes or potential changes to those ratings.

- The significant judgments the company made in classifying a particular financial instrument in the fair value hierarchy.

- An explanation of how credit risk is incorporated and considered in the valuation of assets or liabilities—whether under SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, or other applicable standards.

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- SFAS 159 requires the company to provide disclosure about the gain/loss on items the company elects to carry at fair value but not on those items the company is required to carry at fair value—such as derivative instruments accounted for under SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*. If material to the company's results of operations, consider disclosing the gains or losses on financial instruments that the company is required to carry at fair value and explain:
  - How the company's credit risk affected the company's valuation of derivative liabilities and the resulting gain or loss that the company included in earnings relating to the changes in that credit risk; and
  - How counterparty credit risk affected the company's valuation of derivative assets and the resulting gain or loss that the company included in earnings relating to the changes in that credit risk. Also, consider discussing how deterioration in the counterparty's credit and the company's ability to collect on a derivative asset will impact the company's financial statements.

The location of this information can facilitate an understanding of the impact on the financial statements. Accordingly, the company may want to discuss the implications of items the company elects to carry at fair value with the items that the company is required to carry at fair value.

- The criteria the company used to determine whether the market for a financial instrument is active or inactive (*i.e.*, illiquid).
- Which financial instruments are affected by the lack of market liquidity (*i.e.*, inactivity), how the lack of liquidity impacted the valuation technique the company used, and how the company factored illiquidity into the company's fair value determination of those financial instruments. For example, to the extent the company used a discounted cash flow approach to determine the fair value of a financial instrument, such as auction rate securities, loans held for sale, or mortgage-backed securities backed by subprime or Alt-A collateral, consider discussing the specific change in the discount rate or any other analysis the company performed to account for the lack of liquidity, and discuss how and why the company changed the company's assumptions from prior periods.
- If the company discloses that the company uses brokers or pricing services to assist the company in determining fair values, consider explaining the extent to which, and how, the information is obtained and used in developing the fair value measurements in the consolidated financial statements. The nature and form of this information may vary depending on the facts and circumstances, but may include the following:

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- The nature and amount of assets the company valued using broker quotes or prices the company obtained from pricing services, along with the classification in the fair value hierarchy;

- The number of quotes or prices the company generally obtained per instrument, and if the company obtained multiple quotes or prices, how the company determined the ultimate value the company used in the company's financial statements;

- Whether, and if so, how and why, the company adjusted quotes or prices the company obtained from brokers and pricing services;

- The extent to which the brokers or pricing services are gathering observable market information as opposed to using unobservable inputs and/or proprietary models in making valuation judgments and determinations;

- Whether the broker quotes are binding or non-binding; and

- The procedures the company performed to validate the prices the company obtained to ensure the fair value determination is consistent with SFAS 157, *Fair Value Measurements*, and to ensure that the company properly classified the company's assets and liabilities in the fair value hierarchy.

In the March and February 2008 letters, the SEC also noted that, regardless of how a company has classified the company's assets and liabilities within the SFAS 157 hierarchy, if the company has not already done so in the company's Form 10-K, the company should consider providing the following additional information in the company's MD&A:

- A general description of the valuation techniques or models the company used with regard to the company's material assets or liabilities. Consider describing any material changes the company made during the reporting period to those techniques or models, why the company made them, and, to the extent possible, the quantitative effect of those changes.

- To the extent material, a discussion of the extent to which, and how, the company used or considered relevant market indices, for example ABX or CMBX, in applying the techniques or models the company used to value the company's material assets or liabilities. Consider describing any material adjustments the company made during the reporting period to the fair value of the company's assets or liabilities based on market indices and the company's reasons for making those adjustments.

- A discussion of how the company validates the techniques or models the company uses. For example, the company may wish to discuss whether and how often the company calibrates the technique or models to market, back-test, or otherwise validate it.

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- A discussion of how sensitive the fair value estimates for the company's material assets or liabilities are to the significant inputs the technique or model uses. For example, consider providing a range of values around the fair value amount the company arrived at to provide a sense of how the fair value estimate could potentially change as the significant inputs vary. To the extent the company provides a range, discuss why the company believes the range is appropriate, identifying the key drivers of variability, and discussing how the company developed the inputs the company used in determining the range. The company may wish to refer to Section V of FR-72 "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations" on Critical Accounting Estimates for guidance.

- If material, a discussion of how increases and decreases in the aggregate fair value of the company's assets and liabilities may affect the company's liquidity and capital resources.

THE FEBRUARY 2010 RELEASE (CLIMATE CHANGE)

On February 2, 2010, the SEC published an interpretive release regarding disclosure related to climate change.[573] The SEC intended the release to provide guidance to public companies regarding the SEC's existing disclosure requirements as applied to climate change matters. The SEC noted that regulatory, legislative and other developments related to climate change could have a significant effect on operating and financial decisions of certain companies. In addition, the SEC noted that companies that may not be directly affected by such developments could nonetheless be indirectly affected by changing prices for goods or services provided by companies that are directly affected and that seek to reflect some or all of their changes in costs of goods in the prices they charge.

As a result of the potential impact of climate change on certain companies, the SEC noted a number of examples of climate change related issues that a company may need to consider when drafting the company's MD&A, including the impact of legislation, regulation and international accords, the indirect consequences of regulation or business trends, and the physical impacts of climate change. The SEC noted that Item 303 of Regulation S-K requires a company to assess whether any of these issues is reasonably likely to have a material effect on the company's financial condition or results of operation. If there is a known uncertainty, such as pending legislation or regulation, the SEC noted that the analysis of whether disclosure is required in MD&A consists of the following two steps:

- First, management must evaluate whether the pending legislation or regulation is reasonably likely to be enacted. Unless management determines that it is not reasonably likely to be enacted, it must proceed on the assumption that the legislation or regulation will be enacted.

[573] SEC Release No. 33-9106 (Feb. 2, 2010) (http://www.sec.gov/rules/interp/2010/33-9106.pdf).

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- Second, management must determine whether the legislation or regulation, if enacted, is reasonably likely to have a material effect on the company, its financial condition or results of operations. Unless management determines that a material effect is not reasonably likely, MD&A disclosure is required. In addition to disclosing the potential effect of pending legislation or regulation, the company would also have to consider disclosure, if material, of the difficulties involved in assessing the timing and effect of the pending legislation or regulation.

THE SEPTEMBER 2010 INTERPRETIVE RELEASE AND PROPOSED RULE

On September 17, 2010, the SEC provided guidance that was intended to improve discussion of liquidity and capital resources in the MD&A.[574] In a separate release on September 17, 2010, the SEC simultaneously proposed amendments to the MD&A disclosure requirements to enhance the disclosure that companies present about short-term borrowings.[575] While the SEC has taken no further action on the proposed amendments, they remain instructive of the views of the SEC staff.

Interpretive Release for Current Disclosure Requirements in the MD&A of Financial Condition and Results of Operation

Liquidity Disclosure. The SEC reminded companies that Item 303(a)(1) of Regulation S-K requires them to "identify and separately describe internal and external sources of liquidity, and briefly discuss any material unused sources of liquidity." This includes the disclosure of known trends, demands, commitments, events or uncertainties that will result in, or that are reasonably likely to result in, the company's liquidity increasing or decreasing in any material way. Adding to the list of issues for management to consider when identifying such trends, demands, commitments events and uncertainties, the SEC also suggested disclosure of the difficulties in accessing the debt markets, reliance on commercial paper or other short-term financing arrangements, maturity mismatches between borrowing sources and the assets funded by those sources, changes in terms requested by counterparties and changes in the valuation of collateral and counterparty risk. If a company's financial statements does not adequately convey the company's financing arrangements or the impact of those arrangements on liquidity, additional narrative disclosure could be required to explain the amounts depicted in the financial statements.

The SEC noted that disclosure is required in the MD&A where a known commitment, event or uncertainty will result in (or is reasonably likely to result in) the company's liquidity increasing or decreasing in a material way. The fact that the existing disclosure requirements did not make specific references to off-balance sheet arrangements or contractual obligations to repurchase transactions that are accounted for as sales, or to any other transfers of financial

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[574] SEC Release No. 33-9144 (Sept. 17, 2010) (http://www.sec.gov/rules/interp/2010/33-9144.pdf).

[575] SEC Release No. 33-9143 (Sept. 17, 2010) (http://www.sec.gov/rules/proposed/2010/33-9143.pdf).

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assets that are accounted for as sales, does not relieve companies from disclosure requirements of Item 303(a)(1). The SEC noted that, in evaluating whether disclosure in the MD&A may be required, the company should consider whether the transaction is reasonably likely to result in the use of a material amount of cash or other liquid assets.

The SEC also stated that companies, particularly banks, should consider describing cash and risk management policies that are relevant to an assessment of their financial condition. Companies that maintain or have access to a portfolio of cash and other investments that is a material source of liquidity should consider providing information about the nature and composition of that portfolio. This should include a description of the assets held and any related market risk, settlement risk or other risk exposure.

Leverage Ratio Disclosures. The SEC reiterated the long-standing approach to disclose financial measures and non-financial measures in the MD&A when a company includes capital or leverage ratio disclosure in its filings with the SEC and there are no regulatory requirements prescribing the calculation of that ratio, or where a company includes capital or leverage ratios that are calculated using a methodology that is modified from its prescribed form. A company must first determine whether the measure is a financial measure. If the measure is a financial measure, the company should then decide whether the measures falls within the scope of the requirements for non-GAAP financial measures and if it does, the company would need to follow the rules and guidance governing the inclusion of non-GAAP financial measures in filings. If the measure is a non-financial measure, the SEC referred the company to the guidance in the December 2003 release.

The SEC stated that any ratio or measure included in a filing should be accompanied by a clear explanation of the calculation methodology. If the financial measure presented is different from other measures commonly used in the company's industry, the company should consider whether a discussion of the differences is necessary and include a discussion of why the measure is necessary.

Contractual Obligations Table Disclosures. The SEC stated that the contractual obligations tabular disclosure should attempt to create a snapshot of cash requirements arising from contractual payment obligations. Companies should develop a presentation method that is clear, understandable and appropriately reflects the categories of obligations that are meaningful in light of its capital structure and business. However, there is flexibility in terms of how exactly the presentation is made. The presentation should reflect company-specific information in a way that is suitable to a company's business. For that reason, the SEC did not give general guidance for questions regarding the presentation of contractual obligations table. Instead, the SEC suggested that the disclosure should be made consistent with the purpose of the contractual obligations table, which is to provide aggregated information about contractual obligations and contingent liabilities and commitments in a single location so as to improve transparency of a company's short-term and long-term liquidity and capital resource needs and to provide context for investors to assess the relative role of off-balance sheet arrangements.

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Proposed Rule for Short-Term Borrowings

The SEC currently requires disclosure about a company's short-term borrowings on an annual basis under the SEC's Industry Guide 3, Statistical Disclosure by Bank Holdings Companies. With the proposal, the SEC intended to require this disclosure on a quarterly and annual basis for all companies that provide an MD&A and for this requirement to be codified in Item 303 of Regulation S-K. Companies would be required to provide disclosure in the MD&A of:

- the amount in each specified category of short-term borrowings at the end of the reporting period and the weighted average interest rate on those borrowings;

- the average amount in each specified category of short-term borrowings;

- for companies meeting the proposed definition of "financial company," the maximum daily amount of each specified category of short-term borrowings during the reporting period; and

- for all other companies, the maximum month-end amount of each specified category of short-term borrowings during the reporting period.

The SEC proposed that "short-term borrowings" should include federal funds purchased and securities sold under agreements to repurchase, commercial paper, borrowings from banks, borrowings from factors or other financial institutions, and any other short-term borrowings reflected on the company's balance sheet. In addition to the tabular data related to short-term borrowings, the proposal would require companies to include narrative discussion in order to provide context for the tabular disclosure. More specifically, the topics proposed to be included in this narrative discussion are:

- a general description of the short-term borrowing arrangements included in each category (including any key metrics or other factors that could reduce or impair the company's ability to borrow under the arrangements and whether there are any collateral posting arrangements) and the business purpose of those arrangements;

- the importance to the company of its short-term borrowing arrangements to its liquidity, capital resources, market-risk support, credit-risk support or other benefits

- the reasons for the maximum amount for the reporting period, including any non-recurring transactions or events, use of proceeds or other information that provides context for the maximum amount; and

- the reasons for any material differences between average short-term borrowings for the reporting period and the period-end short-term borrowings.

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To define "financial companies," the SEC included companies involved to a significant extent in lending, deposit taking, insurance underwriting or providing investment advice, or that are brokers or dealers as defined under Section 3 of the Securities Exchange Act of 1934, as amended. Once a company is established to be a financial company, the SEC stated that such companies should provide particularly robust disclosure about short-term borrowings for its investors. Financial companies should compile and report data for the maximum daily amounts outstanding and the average amounts outstanding during the reporting period computed on a daily average basis. Meanwhile, non-financial companies should report the maximum month-end amounts outstanding. Non-financial companies would also have to disclose the basis used for calculating the average amounts. For companies that engage in both financial and non-financial businesses, they would be allowed to provide disclosure separately for each segment.

The SEC stated that the proposal would amend Form 20-F to require foreign private issuers to provide similar disclosures. The proposed rules would also require small reporting companies to comply with the requirements, though there would be certain exclusions. For instance, smaller reporting companies would be permitted to present information for two fiscal years instead of three. Also, smaller reporting companies would only have to provide information regarding material changes to short-term borrowings on a quarterly basis.

THE OCTOBER 2011 RELEASE (CYBERSECURITY)

On October 13, 2011, the Division of Corporation Finance of the SEC released guidance regarding disclosure obligations relating to cybersecurity risks and cyber incidents.[576] The guidance was given due to the increasing dependence on digital technologies for companies to conduct their operations. The SEC recognized that detailed disclosures could compromise cybersecurity efforts and emphasized that such disclosures are not required under the federal securities law. The SEC stated that although there are no existing disclosure requirement explicitly referring to cybersecurity risks and cyber incidents, a number of disclosure requirements may impose an obligation on companies to disclose such risks and incidents.

For the MD&A, companies should address cybersecurity risks and cyber incidents if the costs or other consequences associated with such incidents or the risk of potential incidents represent a material event, trend or uncertainty. However, companies only have to disclose such information if the material event, trend or uncertainty is reasonably likely to have a material effect on the company's results of operations, liquidity or financial conditions or would cause reported financial information not to be necessarily indicative of future operating results or financial condition. Using the theft of intellectual property as an example, the SEC stated that the company should describe what was affected by the attack and the effect of the attack on its results of operations, liquidity, and financial condition and

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[576] CF Disclosure Guidance: Topic No. 2 - Cybersecurity (October 13, 2011) (http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm).

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whether the attack would cause financial information not to be indicative of future operating results of financial condition. If it is reasonably likely that the attack will lead to reduced revenues or an increase in cybersecurity protection costs, the company should discuss these possible outcomes if material.

DIVISION OF CORPORATION FINANCE: DISCLOSURE GUIDANCE

The Division of Corporation Finance of the SEC provides guidance on specific disclosure topics through Disclosure Guidance Topics, Staff Reports and sample comment letters and other SEC staff guidance posted on its web site at http://www.sec.gov/divisions/corpfin/cfdisclosure.shtml.

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APPENDIX E

REGULATION OF ACTIVITIES OF U.S. BANKS IN THE UNITED STATES

APPENDIX E

REGULATION OF ACTIVITIES OF U.S. BANKS IN THE UNITED STATES

LEGAL FRAMEWORK E-1
THE DODD-FRANK ACT E-3
BASEL III.. E-20
MONEY LAUNDERING AND TERRORIST FINANCING E-34

LEGAL FRAMEWORK

Supervision of Banks

In the United States, U.S. banks are chartered and supervised by federal or state authorities under a dual banking system. At the federal level, national banks are chartered, regulated and supervised by the OCC under the National Bank Act.[577] In addition to the OCC as their primary regulator, national banks receive secondary oversight from the FDIC, which regulates banks that offer insured deposits under the federal deposit insurance program. National banks are also members of the Federal Reserve System. At the state level, state banks are chartered, regulated and supervised by state banking agencies, and also regulated by a primary federal regulator working in cooperation with the state regulator. State-chartered banks that choose to be members of the Federal Reserve System are regulated by the Board of Governors of the Federal Reserve System (“Federal Reserve”), and state-chartered non-member banks are regulated by the FDIC. U.S. banks can therefore be subject to various federal and state laws and regulations. Banking regulators are responsible for overseeing the safety and soundness of banks, and their functions may include providing rulemaking and guidance, conducting on-site examinations and off-site monitoring, through reporting requirements, approving applications for branches, mergers and acquisitions, issuing enforcement actions and penalties, and placing restrictions on banking activities.

Bank Holding Companies and Bank Holding Company Act

A bank holding company (“BHC”) is defined under the Bank Holding Company Act of 1956 (the “BHC Act”) as any company that either controls a bank or controls another company that controls a bank.[578] A company must first obtain Federal Reserve approval to become a bank holding company. Upon becoming a bank holding company, the BHC is

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[577] 12 U.S.C. §1 *et seq.*

[578] 12 U.S.C. §1841(a).

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supervised and examined by the Federal Reserve and its activities are subject to the BHC Act and the Federal Reserve's Regulation Y.[579]

The BHC Act generally prohibits a BHC from owning or controlling any company other than a bank or bank holding company, or engaging in activities that are not so closely related to banking as to be a proper incident thereto.[580] BHCs must obtain the approval of, or provide appropriate notice to, the Federal Reserve prior to engaging in non-banking activities or investments unless an exemption is available. Under the BHC Act's 4(c)(6) exemption, for example, a BHC can make a passive investment in any entity if the investment is less than 5% of any class of voting security and less than 25% of the total equity (voting and non-voting) of the entity without receiving prior Federal Reserve approval.

BHCs are expected to serve as a source of financial strength to their subsidiary banks in the event of financial distress. This "source of strength doctrine" has been codified under Section 616 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[581]

Financial Holding Companies

The Gramm-Leach-Bliley Act of 1999 ("GLB Act") amended the BHC Act to permit BHCs to expand their powers by becoming a financial holding company ("FHC"). FHCs may engage in, or own or control companies engaged in, activities that are financial in nature, or incidental or complementary to a financial activity.[582] Therefore, FHC status essentially permits a BHC to engage in a broader range of activities, including securities underwriting and dealing, merchant banking investments, and insurance underwriting.

Like BHCs, FHCs are supervised and examined by the Federal Reserve. A BHC must elect (*i.e.*, file a declaration and certification) and qualify to become an FHC. Prior to the passage of the Dodd-Frank Act, a U.S. BHC qualified for financial holding company status if all insured depository institutions controlled by the BHC were "well-capitalized" and "well-managed," and received at least a satisfactory rating under the Community Reinvestment Act of 1977. To be well-capitalized required maintaining a Tier 1 risk-based capital ratio of at least 6%, total risk-based capital ratio of at least 10%, and a leverage ratio of at least 5%, and to be well-managed required receiving satisfactory management and composite ratings at the most recent examination.[583] Section 606 of the Dodd-Frank Act amends the BHC Act to require the FHC itself, in addition to its insured depository institution subsidiaries, to be well-capitalized and well-managed. The standards for being

[579] 12 C.F.R. §225.

[580] 12 U.S.C. §1843(a).

[581] Dodd-Frank Act, Pub. L. No. 111-203 (2010).

[582] 12 U.S.C. §1843(k)(1).

[583] 12 U.S.C. §1843(l); 12 C.F.R. §§225.2, 225.81- 225.85.

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well-capitalized, however, will change as capital requirements are enhanced. In their efforts to implement Basel III in the United States, U.S. banking regulators have recently proposed to define "well-capitalized" as a Tier 1 risk-based capital ratio of at least 8%, total risk-based capital ratio of at least 10%, common equity Tier 1 risk-based capital ratio of at least 6.5% and a leverage ratio of at least 5%.[584] Failure of an FHC to maintain the well-capitalized and well-managed requirements can result in activities being restricted under a Section 4(m) agreement or potential loss of FHC status.

The Federal Reserve's role as the "umbrella supervisor" of BHCs and FHCs is to review and assess the operations and financial condition of the consolidated organization. When a BHC or FHC owns a functionally-regulated subsidiary such as, for example, a broker-dealer that is regulated by the SEC or an insurance company regulated by state insurance authorities, the Federal Reserve coordinates its supervisory activities with those of the subsidiary's functional regulator to avoid duplication of efforts. The Dodd-Frank Act expands the Federal Reserve's authority to require reports from and examine holding company subsidiaries, including functionally-regulated subsidiaries. However, the Federal Reserve must provide reasonable notice and consult with the primary regulator before commencing an examination of the subsidiary, and rely on existing examination reports and other information to the fullest extent possible to avoid duplication of examination activities, reporting requirements and information requests.

THE DODD-FRANK ACT

In the wake of the recent financial crisis, the enactment of the Dodd-Frank Act set in motion an extensive restructuring of the U.S. financial regulatory framework that would have significant effects on U.S. banks and bank holding companies. Some of the major changes made by the Dodd-Frank Act include affiliate transaction restrictions, resolution plans, restrictions on proprietary trading and investments in funds under the Volcker Rule, derivatives regulation, and enhanced capital, leverage and liquidity requirements. Each of these topics are briefly discussed below.

Affiliate Transaction Restrictions

Banking regulators have long regarded transactions between banks and their affiliates as a primary concern because in times of severe financial stress, the parent holding companies may be tempted to divert resources from their bank subsidiaries to other affiliates in transactions that are not arm's-length. Sections 23A and 23B of the Federal Reserve Act ("FRA") and the Federal Reserve's Regulation W ("Regulation W") seek to safeguard against such conduct by restricting transactions between banks and their affiliates.[585] Title VI of the Dodd-Frank Act further expands some of these restrictions.

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[584] See 77 Fed. Reg. 52792 (Aug. 30, 2012).

[585] 12 U.S.C. §§371c, 371c–1; 12 C.F.R. §223.

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Section 23A

Section 23A of the FRA imposes several limitations on certain transactions (referred to as "covered transactions") between banks and their affiliates. "Affiliate" for Section 23A purposes is defined as:

- any company that controls the bank or is controlled by the company that controls the bank;[586]

- a bank subsidiary of the bank;

- any company that is controlled, by a trust or otherwise, by the controlling shareholders of the bank or a company that controls the bank;

- any company in which a majority of its directors are also a majority of the directors of the bank or a company that controls the bank;

- any investment fund with respect to which the bank or its affiliate is an investment adviser; and

- any company that the Federal Reserve determines to have a relationship with the bank or any subsidiary or affiliate of the bank, such that covered transactions by the bank or its subsidiary with that company may be affected by the relationship to the detriment of the bank or its subsidiary.

Transactions with third parties are deemed to be a transaction with an "affiliate" to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate. Certain companies are excluded from the definition of "affiliate," such as nonbank subsidiaries of banks (other than financial subsidiaries), companies engaged solely in holding the premises of the bank or conducting a safe-deposit business, companies engaged solely in holding U.S. government obligations, and companies where control results from the exercise of rights created out of a *bona fide* debt previously contracted (limited to a specific period).

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[586] The term "control" generally means (1) ownership, control or having the power to vote 25% or more of any class of voting security of the other company, (2) control in any manner the election of a majority of the board of directors (or individuals exercising similar functions) of the other company, or (3) the Federal Reserve determines, after notice and opportunity for a hearing, that there is an exercise of a controlling influence over the management and policies of the other company. The term generally does not include ownership or control of shares in a fiduciary capacity. See 12 C.F.R. §223.3(g).

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Under Section 23A, as implemented by Regulation W, "covered transactions" between a bank and its affiliates are subject to the following quantitative and qualitative restrictions:

- Covered transactions between a bank (including its subsidiaries) and any single affiliate may not exceed 10% of the bank's capital and surplus;
- Covered transactions between a bank (including its subsidiaries) and all affiliates in the aggregate may not exceed 20% of the bank's capital and surplus;
- A bank and its subsidiaries may not purchase low-quality assets from an affiliate; and
- Covered transactions between a bank and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices.

"Covered transaction" is defined as:

- a loan or extension of credit to an affiliate, including a purchase of assets subject to a repurchase agreement;
- a purchase of, or an investment in, securities issued by an affiliate;
- a purchase of assets from an affiliate other than real and personal property specifically exempted by the Federal Reserve;
- the acceptance of securities issued by the affiliate as collateral for a loan or extension of credit to any person; or
- the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate.

The Dodd-Frank Act expands this list of "covered transactions" to include: (a) derivatives transactions and securities borrowing and lending transactions with an affiliate, to the extent they result in credit exposure to the affiliate, and (b) the acceptance of debt obligations (other than securities) issued by an affiliate as collateral for a loan or extension of credit to any person. The term "credit exposure" is not defined by the Dodd-Frank Act and will likely be defined by regulation.

Certain transactions are exempt from the preceding restrictions, other than the requirement that the transactions be on terms and conditions consistent with safe and sound banking practices, in order to recognize those transactions that are necessary for ordinary bank operations or where the potential for bank abuse is minimal. Exempted transactions include:

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- any transaction, other than a purchase of low-quality assets, with an affiliated bank in which there is a control relationship involving 80% or more of the voting shares;
- deposits in an affiliated bank in the ordinary course of correspondent business;
- credit given to an affiliate for uncollected items received in the ordinary course of business;
- a loan or extension of credit to an affiliate that is fully secured by U.S. government obligations or a segregated, earmarked deposit account at the bank;
- a purchase of securities issued by a company engaged in certain operational activities for the bank;
- a purchase of assets with a readily and publicly available market quotation at or below the quotation price;
- a purchase of loans on a nonrecourse basis from an affiliated bank subject to the prohibition on the purchase of low-quality assets; and
- a purchase from an affiliate of a loan or extension of credit that was originated by the bank and sold to the affiliate subject to a repurchase agreement or with recourse.

The Dodd-Frank Act allows netting agreements to be taken into account when determining the amount of a covered transaction between a bank (or its subsidiary) and an affiliate. Netting agreements may also be taken into account when determining if the amount of an extension of credit or other credit exposure is fully secured by U.S. government securities or a segregated deposit account and is thereby an exempted transaction. The Federal Reserve and federal banking agency for a bank or its affiliate must jointly issue an interpretation to take into account the effect of a netting agreement between the bank (or its subsidiary) and an affiliate.

Section 23A also sets forth mandatory collateral requirements for certain covered transactions. Loans or extensions of credit to, and guarantees, acceptances or letters of credit issued on behalf of, an affiliate by a bank (or its subsidiary) must be secured by collateral with a market value of 100% to 130% of the amount of the credit, depending on the nature of the collateral. In addition, the Dodd-Frank Act makes the following amendments to the collateral requirements:

- Collateral requirements need to be satisfied at all times, rather than only at the time the transaction is entered into and when collateral is retired or amortized;
- The scope of covered transactions subject to the collateral requirement is expanded to include any credit exposure to an affiliate resulting from a derivative

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transaction or securities borrowing or lending transaction, as well as any credit exposure on repurchase agreements;

- Debt obligations issued by an affiliate are no longer eligible to satisfy the collateral requirements; and
- The prohibition on the acceptance of low-quality assets or securities issued by an affiliate as collateral for an extension of credit to, or on behalf of, an affiliate has been extended to derivatives and securities lending transactions.

The Federal Reserve has traditionally had sole discretion to issue exemptions from Section 23A affiliate transaction rules. Procedural changes under the Dodd-Frank Act now restricts this authority, such as providing the OCC and the FDIC with the authority, in certain circumstances, to approve exemptions by order with concurrence from the Federal Reserve.

Section 23B

Section 23B of the FRA imposes an arm's-length standard for bank transactions with affiliates. Such transactions must be on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving non-affiliated companies. In the absence of comparable transactions, such transactions must be on terms and under circumstances that in good faith would be offered or apply to non-affiliated companies.

Section 23B applies to any covered transactions defined under Section 23A, as well as other specified transactions with an affiliate (excluding banks) or in which an affiliate has a financial interest. Other specified transactions under Section 23B include the sale of securities or assets to an affiliate (including assets subject to repurchase agreements), the payment of money or furnishing of services to an affiliate, and any transaction in which an affiliate acts as agent or broker or receives a fee for its services to the bank or any other person.

Resolution Plans (Living Wills)

Section 165(d) of the Dodd-Frank Act requires large bank holding companies and systemically significant nonbank financial companies to periodically submit to the Federal Reserve, the FDIC and the Financial Stability Oversight Council ("FSOC") comprehensive resolution plans (so-called "living wills") for the rapid and orderly resolution of the company in the event of material financial distress or failure ("DFA Resolution Plans"). In October 2011, the FDIC and the Federal Reserve jointly approved a final rule (the "DFA Resolution Plan Rule") to implement the resolution plan requirements.[587]

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[587] 76 Fed. Reg. 67323 (Nov. 1, 2011).

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The DFA Resolution Plan Rule applies to (1) nonbank financial companies that are supervised by the Federal Reserve and (2) U.S. bank holding companies and non-U.S. banks that are treated as bank holding companies with $50 billion or more in total consolidated assets on a global basis (collectively, "Covered Companies"). The deadlines for Covered Companies to submit their initial DFA Resolution Plans are staggered into three groups:

- ***Group 1*** – July 1, 2012 for Covered Companies with at least $250 billion in total nonbank assets (for non-U.S. Covered Companies, at least $250 billion in total U.S. nonbank assets), as of the DFA Resolution Plan Rule's effective date (*i.e.*, November 30, 2011);

- ***Group 2*** – July 1, 2013 for Covered Companies with at least $100 billion but less than $250 billion in total nonbank assets (for non-U.S. Covered Companies, at least $100 billion but less than $250 billion in total U.S. nonbank assets), as of the DFA Resolution Plan Rule's effective date;

- ***Group 3*** – December 31, 2013 for Covered Companies with less than $100 billion in total nonbank assets (for non-U.S. Covered Companies, less than $100 billion in total U.S. nonbank assets), as of the DFA Resolution Plan Rule's effective date; and

- A company that becomes a Covered Company after the DFA Resolution Plan Rule's effective date must submit its initial plan by the following July 1, provided that such date is at least 270 days after the date the company becomes a Covered Company.

Thereafter, a Covered Company must submit an updated DFA Resolution Plan annually. Each Covered Company must also provide notice of any event or change in circumstances that results in, or could reasonably be foreseen to have, a material effect on its DFA Resolution Plan within forty-five days after the event or change, unless its annual plan is due within ninety days.

A DFA Resolution Plan must explain how a Covered Company may be reorganized or liquidated under the U.S. Bankruptcy Code or other applicable insolvency regime in the event of material financial distress or failure, in a manner that mitigates serious adverse effects to U.S. financial stability. The strategy must take into consideration not only failure of the Covered Company, but also failure of the Covered Company's material entities, core business lines and critical operations (U.S. and foreign). The strategy must also include assumptions for material financial distress or failure that occur under baseline, adverse and severely adverse economic conditions as specified by the Federal Reserve. The contents of the DFA Resolution Plan include: (1) an executive summary of the key elements of the plan, material changes, and actions to improve or remedy the plan; (2) a strategic analysis explaining the plan for a rapid and orderly resolution; (3) a description of the corporate governance structure for resolution planning; (4) a detailed description of the overall organizational structure; (5) a detailed description of management information systems; (6) identification of interconnections and interdependencies among the Covered Company,

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its material entities, critical operations and core business lines; (7) identification of supervisory authorities and regulators; and (8) contact information for the Covered Company and its material entities. The DFA Resolution Plan Rule must be approved by the Covered Company's board of directors.

To lessen the regulatory burden for smaller Covered Companies and non-U.S. Covered Companies with limited U.S. operations, the DFA Resolution Plan Rule created a "tailored plan" option. The tailored plan would include all the elements in a standard plan, but can limit the information provided for some of the elements to the Covered Company and its nonbanking material entities and operations. A Covered Company is eligible to file a tailored plan if (1) it has less than $100 billion in total nonbank assets (in the case of a non-U.S. Covered Company, in total U.S. nonbank assets) and (2) its total insured depository institution assets comprise 85% or more of the Covered Company's total consolidated assets (in the case of a non-U.S. Covered Company, the assets of U.S. insured depository institutions, branches, and agencies comprise 85% or more of the company's U.S. total consolidated assets). A company that intends to file a tailored plan must file a notice with the Federal Reserve and FDIC no later than 270 days prior to its submission date.

Once a DFA Resolution Plan is submitted, within sixty days the Federal Reserve and FDIC (the "Agencies") must jointly determine whether the plan is informationally complete or requires additional information. If incomplete, the Covered Company will be notified and has thirty days to resubmit a complete plan. After a plan is accepted as complete, the Agencies will evaluate whether the plan is credible and would facilitate an orderly resolution under the Bankruptcy Code. If they find deficiencies, the Covered Company will be notified and has ninety days to resubmit a plan that addresses the deficiencies. A failure to cure the deficiencies could subject the Covered Company or its subsidiary to more stringent capital, leverage or liquidity requirements, or restrictions on growth, activities or operations. After two years, the Covered Company may be directed to divest certain assets or operations that are deemed necessary for an orderly resolution of the company.

The confidentiality of submitted resolution plans are based on applicable exemptions under the Freedom of Information Act (5 U.S.C. 552(b)) and Agency rules. Covered Companies need to divide their plans into public and confidential sections, and request confidential treatment for the confidential sections in accordance with applicable exemptions. The public section should include sufficient details that describe the business of the company, such as core business lines, material entities and financial information regarding assets, liabilities, capital and major funding sources.

On a separate but related rulemaking, in January 2012 the FDIC adopted a final rule that requires an insured depository institution with $50 billion or more in total assets ("Covered IDI") to submit to the FDIC annual resolution plans in the event of the institution's failure (the "IDI Resolution Plan").[588] The IDI Resolution Plan should enable

[588] 77 Fed. Reg. 3075 (Jan. 23, 2012); 12 C.F.R. §360.10.

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the FDIC, as receiver, to proceed with the rapid and orderly resolution of the IDI under Sections 11 and 13 of the Federal Deposit Insurance Act in a manner that ensures depositors will receive access to insured deposits within one to two business days, maximizes the net return from the disposition of assets, and minimizes loss to creditors.[589] The plan can incorporate information provided in the DFA Resolution Plan of the Covered IDI's parent holding company. The final rule became effective on April 1, 2012 and is intended to closely complement the requirements of the DFA Resolution Plan Rule. Covered Companies with Covered IDI subsidiaries would file an IDI Resolution Plan, in addition to a DFA Resolution Plan.

Volcker Rule

Section 619 of the Dodd-Frank Act (known as the "Volcker Rule") prohibits banking entities from (1) engaging in proprietary trading and (2) acquiring or retaining an ownership interest in, or sponsoring, a private equity fund, hedge fund or similar fund ("covered funds"), subject to exemptions.[590] The Federal Reserve, FDIC, OCC and the SEC proposed regulations to implement the Volcker Rule in October 2011, and the CFTC proposed regulations in January 2012 that closely follow the October 2011 proposed regulations (collectively, the "proposed regulations").[591] Since then, the proposed regulations generated numerous comments and criticism from the banking industry. The regulators continue to work on hammering out all the issues, and a final version is expected to be released sometime in 2013.

The proposed regulations define a "banking entity" as any insured depository institution ("IDI"), any company that controls an IDI, any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of the foregoing (other than covered funds that are organized, offered or held by a banking entity or entities controlled by such covered funds).

Proprietary Trading Restrictions

The Volcker Rule generally prohibits banking entities from engaging in proprietary trading, which is defined as engaging as principal for the trading account of the banking entity in any purchase or sale of covered financial positions, subject to certain exceptions.

"Trading account" is defined as an account used to acquire or take financial positions that are (1) for the purposes of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging one or more such

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589 12 U.S.C. §§1821,1823.

590 Section 619 of the Dodd-Frank Act adds a new section 13 to the BHC Act.

591 76 Fed. Reg. 68846 (Nov. 7, 2011) (proposal of the OCC, Federal Reserve, FDIC and SEC); 77 Fed. Reg. 8332 (Feb. 14, 2012) (proposal of the CFTC).

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positions, (2) deemed to be a covered position under the federal banking agencies' market risk capital rules, other than certain foreign exchange and commodities positions or (3) held by the banking entity as a SEC-registered securities or municipal securities dealer, government securities dealer, registered swap dealer or security-based swap dealer, or similar dealer outside the U.S. The proposed regulations include a rebuttable presumption that any account used to acquire or take a covered financial position (other than a trading account described in clause (2) or (3) of the definition) that is held for sixty days or less is a trading account, unless the banking entity can demonstrate that the position was not acquired principally for short-term trading purposes. Accounts used for repurchase and securities lending agreements, and *bona fide* liquidity management are excluded as trading accounts. "Covered financial positions" include long, short, synthetic and other positions in securities, derivatives, commodity futures and options on such instruments, but exclude positions in loans, spot foreign exchange or spot commodities.

Exemptions to the prohibition on proprietary trading include:

- trading in certain U.S. government obligations (including those of government-sponsored entities);
- underwriting and market making-related activities;
- risk-mitigating hedging activities;
- trading on behalf of customers;
- trading by a regulated insurance company and its affiliates for the general account of the insurance company; and
- trading outside the U.S. by non-U.S. banking entities.

The proposed regulations set forth certain criteria that must be satisfied to utilize many of these exemptions. Furthermore, any such permissible trading activities may not (1) involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties, (2) result in material exposure by the banking entity to a high-risk asset or high-risk trading strategy, or (3) pose a threat to the safety and soundness of the banking entity or U.S. financial stability. The proposed regulations define material conflict of interest, high-risk asset, and high-risk trading strategy for these purposes.

Banking entities with significant covered trading activities must comply with reporting and recordkeeping requirements set forth in Appendix A of the proposed regulations. Appendix A applies to any banking entity that, together with its affiliates and subsidiaries, has trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) is at least $1 billion. These banking entities must furnish periodic reports to the relevant regulatory agency providing a variety of quantitative measurements of their covered trading activities and maintain records documenting the preparation and content of these reports. The reporting and recordkeeping requirements vary

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depending on the scope, type and size of covered trading activities, and should be incorporated into the banking entity's internal compliance program discussed in below under the Section "Compliance Program".

Covered Fund Activities and Investments

The Volcker Rule prohibits a banking entity from sponsoring, or acquiring or retaining (as principal) any ownership interest in a covered fund, with certain exceptions. The definition of "covered fund" generally parallels the statutory definitions of "hedge fund" and "private equity fund" under Section 13(h)(2) of the BHC Act and means any issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7) of that Act or such similar funds as the regulatory agencies may designate by rule. The proposed regulations have proposed to include as "similar funds" a commodity pool, as well as the non-U.S. equivalent of any entity identified as a "covered fund." The term "sponsor" is defined as an entity that: (1) serves as a general partner, managing member, trustee, or commodity pool operator of a covered fund; (2) in any manner selects or controls (or has employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or (3) shares with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

The proposed regulations exempt certain covered fund activities and investments from the prohibition against sponsoring, or acquiring or retaining any ownership interest in a covered fund (referred to as "permitted activities and investments").

Asset Management and Advisory Services

A banking entity may organize and offer a covered fund if the following eight conditions are satisfied:

(1) the banking entity must provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services;

(2) the covered fund must be organized and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity;

(3) any ownership interest in the covered fund held by the banking entity must be *de minimis* (as discussed under "De Minimis Investments" below);

(4) the banking entity must comply with the restrictions governing covered transactions with covered funds under Section 23A (as described below) and Section 23B of the FRA;

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(5) the banking entity may not guarantee or otherwise insure the obligations or performance of the covered fund or any covered fund in which such covered fund invests;

(6) the covered fund may not share the same name or a variation thereof with the banking entity, or use the word "bank" in its name;

(7) only a director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund may take or retain an ownership interest in the covered fund; and

(8) the banking entity must (A) make certain disclosures to investors in the covered fund set forth in the proposed regulations, and (B) comply with any additional agency rules designed to ensure that losses in such covered fund are borne solely by investors and not by the banking entity.

De Minimis Investments

A banking entity may invest in a covered fund that the banking entity organizes and offers as described under "Asset Management and Advisory Services" above, for the purposes of (1) establishing the covered fund and providing the fund with sufficient initial equity to permit the fund to attract unaffiliated investors or (2) making a *de minimis* investment in the covered fund. The banking entity's investment in any one covered fund may not exceed 3% of the total outstanding ownership interests in the covered fund. The 3% limit can be temporarily exceeded for purposes of establishing and providing the fund with initial equity. However, the banking entity must reduce its ownership interest to 3% within one year after the establishment of the fund. In addition, the banking entity's aggregate investments in all covered funds may not exceed 3% of the banking entity's Tier 1 capital. Certain amounts invested in covered funds must be deducted from the banking entity's Tier 1 capital for bank regulatory calculations.

Other Permitted Activities

The proposed regulations also include provisions permitting a banking entity to acquire and retain an ownership interest in, or act as sponsor to:

(1) small business investment companies (SBICs), a public welfare investment, or certain qualified rehabilitation expenditures;

(2) in the case of certain eligible non-U.S. banking entities, a covered fund solely outside the U.S. that is not offered for sale or sold to U.S. residents and meets certain other criteria;

(3) a bank owned life insurance (BOLI) separate account;

(4) a joint venture that is an operating company and does not engage in any activity or investment not permitted under the proposed regulations;

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(5) an acquisition vehicle with a sole purpose to effect a merger or acquisition of one entity with or into the banking entity or an affiliate;

(6) a wholly-owned subsidiary engaged principally in *bona fide* liquidity management activities and carried on the balance sheet of the banking entity; and

(7) certain issuers of asset-backed securities, such as loan securitization vehicles.

Banking entities may also acquire and retain an ownership interest in a covered fund as a risk-mitigating hedging activity, or when the ownership interest is obtained in the ordinary course of collecting a debt previously contracted in good faith if the interest is divested within applicable time periods.

None of the permitted activities and investments may, however, (1) involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties, (2) result in material exposure by the banking entity to a high-risk asset or high-risk trading strategy, or (3) pose a threat to the safety and soundness of the banking entity or U.S. financial stability.

Super 23A

The Volcker Rule generally prohibits a banking entity from entering into Federal Reserve Act Section 23A "covered transactions" with any covered fund that it advises, manages or sponsors or any covered fund that is controlled by such fund (referred to as "Super 23A"), as if the banking entity were a bank and the covered fund were an affiliate. Super 23A is more restrictive than Section 23A, which permits covered transactions with affiliates as long as the transactions meet specific quantitative and qualitative requirements. Super 23A also applies to all banking entities, not just banks, and the standard exempted transactions available under Section 23A do not apply.

However, the proposed regulations clarify that a banking entity is permitted to invest in securities issued by a related covered fund in accordance with other provisions of the proposed regulations, even though the purchase of securities is a covered transaction under Section 23A. There is also a limited exemption for prime brokerage transactions. A banking entity could provide certain prime brokerage services and products, such as custody, clearance, securities borrowing or lending, trade execution or financing, data, operational and portfolio management support, to any covered fund in which a covered fund managed, sponsored or advised by the banking entity has taken an ownership interest. These prime brokerage services must be performed on an arm's-length basis as per the requirements of Section 23B of the FRA. The chief executive officer (or equivalent officer) of the banking entity must certify in writing annually that the banking entity does not guarantee or otherwise insure the obligations of the covered fund or of any covered fund in which such covered fund invests.

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Compliance Program

The proposed regulations require certain banking entities to establish a compliance program designed to ensure compliance with the prohibitions and restrictions under the Volcker Rule. The program must be appropriate for the size, scope and complexity of the activities and business structure of the entity.

If a banking entity does not engage in covered trading activities and covered fund activities and investments, it must ensure that its existing compliance policies and procedures include measures designed to prevent the banking entity from becoming engaged in such activities and making such investments. If a banking entity engages in covered trading activities or covered fund activities, it should maintain an effective compliance program that contains, at a minimum, the following six elements:

(1) internal written policies and procedures reasonably designed to document, describe and monitor covered trading and fund activities to ensure compliance;

(2) a system of internal controls reasonably designed to monitor and identify potential areas of noncompliance in the banking entity's covered trading and fund activities and to prevent the occurrence of prohibited activities;

(3) a management framework that clearly delineates responsibility and accountability for compliance;

(4) independent testing for the effectiveness of the compliance program, conducted by qualified banking entity personnel or a qualified outside party;

(5) training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and

(6) recordkeeping sufficient to demonstrate compliance, which a banking entity must promptly provide to the relevant regulatory agency upon request and retain for a period of no less than five years.

In addition, banking entities with significant covered trading activities or covered fund activities and investments must implement a compliance program that meets additional minimum standards provided in Appendix C of the proposed regulations. Banking entities subject to the enhanced compliance program requirements generally include any entity that (i) engages in proprietary trading and has trading assets and liabilities on a consolidated basis equal to or greater than $1 billion or equal to or greater than 10% of total assets, (ii) has aggregate investments in covered funds equal to or greater than $1 billion, or (iii) sponsors or advises one or more covered funds, the average total assets of which are equal to or greater than $1 billion.

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Effective Date and Conformance Period

The Volcker Rule became effective on July 21, 2012 even though regulations have not been finalized. Banking entities have been given until July 21, 2014 to fully conform their activities and investments to the Volcker Rule and any implementing regulations. The Federal Reserve may extend the conformance period with three separate one-year extensions, plus an additional period of up to five years for investments in illiquid funds.

During the conformance period, banking entities are expected to make good-faith planning efforts to conform their activities and investments to the Volcker Rule and implementing regulations by no later than the end of the conformance period, including the implementation of a specific conformance plan. Banking entities may also need to comply with reporting and recordkeeping requirements in the final regulations if they are required during the conformance period.[592] Until a final rule is issued, banking entities will need to make preparations based on the proposed regulations.

Derivatives Regulation

Title VII of the Dodd-Frank Act contains a comprehensive framework for the regulation of the over-the-counter swap markets. The CFTC and the SEC share rulemaking authority, with the CFTC having jurisdiction over "swaps," the SEC having jurisdiction over "security-based swaps," and both the CFTC and the SEC sharing jurisdiction over "mixed swaps" which contain both swap and security-based swap characteristics. The federal banking regulators, however, retain authority over setting capital and margin requirements for swap entities that are banks. "Security-based swaps" are broadly defined as swaps based on a single security or loan, a narrow-based group or index of securities, or events relating to a single issuer or issuers of securities in a narrow-based security index. "Swaps" include a broad range of swaps that are not security-based swaps, but exclude, among other things, nonfinancial or security forwards that are intended to be physically settled, futures contracts and securities options. The Secretary of the Treasury has determined that FX swaps and FX forwards shall be exempted from the definition of "swaps," but they must still be reported to a swap data repository or, if none is available, to the applicable regulator, and the parties must conform to business conduct standards. To date, both the CFTC and the SEC have issued numerous proposed rules and finalized some rules, including rules to clarify key definitions.

Title VII requires a swap or security-based swap to be submitted for clearing if the applicable regulator determines that it should be cleared and a registered clearing organization or agency will accept the swap for clearing, unless an exception applies. One exception (the "end-user exception") allows a swap counterparty to elect not to clear the

[592] 76 Fed. Reg. 8265 (Feb. 14, 2011); Federal Reserve's "Statement of Policy Regarding the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities," 77 Fed. Reg. 33949 (Jun. 8, 2012).

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swap if the counterparty is not a "financial entity," is using the swap to hedge or mitigate commercial risk and notifies the CFTC or the SEC, in a manner prescribed by the CFTC or the SEC, how it generally meets its financial obligations associated with entering into non-cleared swaps.[593] The end-user exception is available to "SEC Filers" only if an appropriate committee of the board or governing body has reviewed and approved the decision to enter into the swap. An "SEC Filer" is a company with securities registered under Section 12 of the Securities Exchange Act of 1934 or that is required to file reports pursuant to Section 15(d) of the Securities Exchange Act of 1934. If a swap or security-based swap is subject to mandatory clearing, it must be traded on a regulated exchange or swap execution facility, unless there is no exchange or swap execution facility that will accept the swap for trading. All swaps with a counterparty that is not an eligible contract participant must be traded on an exchange. Cleared and uncleared swaps are reported to a registered swap data repository.

The Dodd-Frank Act also establishes two new categories of market participants, (1) swap dealers and (2) major swap participants as those terms are defined by statute and regulation. Swap dealers and major swap participants must register with either or both the CFTC and the SEC, depending on whether they act as dealers for or are major participants in swaps and/or security-based swaps. The CFTC and the SEC (and in the case of banks, the federal banking regulators) are directed to set minimum capital requirements and initial and variation margin requirements for swap dealers and major swap participants. Swap dealers and major swap participants are also required to comply with business conduct standards, conflict of interest rules, and recordkeeping and reporting requirements.

Section 716 of the Dodd-Frank Act (also known as the "swaps push-out rule") prohibits certain types of Federal assistance to swaps entities such as major swap participants (excluding insured depository institutions) and swap dealers. "Federal assistance" includes, among other things, the use of advances from any Federal Reserve credit facility or discount window that is not part of a broad-based eligibility program, or FDIC deposit insurance or guarantees. The prohibition does not apply to insured depository institutions that limit their swaps activities to hedging and other similar risk mitigating directly related to such activities, and swaps involving rates or reference assets that are permissible for investment by national banks (other than uncleared credit default swaps). Subject to these exceptions, insured depository institutions could push out their swap activities to an affiliate, as long as the insured depository institution is part of a bank holding company or savings and loan holding company supervised by the Federal Reserve, and the entities comply with the affiliate transaction restrictions under Sections 23A and 23B of the Federal Reserve Act and any other

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[593] The term "financial entity" generally means a swap dealer, a securities-based swap dealer, a major swap participant, a major securities-based swap participant, a commodity pool, a private fund, an employee benefit plan or a person predominantly engaged in the business of banking or in activities that are financial in nature, but excludes certain captive finance companies that use derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures. The CFTC and SEC are authorized to exempt small banks, savings associations, farm credit system institutions and credit unions. In a final rule, the CFTC exempted these entities if their total assets do not exceed $10 billion.

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requirements imposed by the regulators. The effective date for the swaps push-out rule is July 16, 2013. Section 716 provides insured depository institutions with a transition period up to two years to transfer impermissible activities to an affiliate, or cease them altogether. The transition period can be extended by the appropriate federal banking regulator for an additional year.

Capital, Leverage and Liquidity Requirements

As a result of the recent financial crisis, U.S. banking regulators have focused more attention on addressing weaknesses in regulatory capital, leverage and liquidity requirements for banking organizations. The Dodd-Frank Act imposes a number of more stringent prudential standards that affect both banks and bank holding companies.

Section 171 of the Dodd-Frank Act (the "Collins Amendment") directs U.S. banking regulators to establish minimum leverage and risk-based capital requirements for insured depository institutions ("IDIs"), depository institution holding companies and nonbank financial companies supervised by the Federal Reserve. The minimum requirements must not be less than "generally applicable" leverage and risk-based capital requirements that apply to IDIs under the prompt corrective action ("PCA") provisions of the Federal Deposit Insurance Act, and not quantitatively lower than the generally applicable leverage and risk-based capital requirements that were in effect for IDIs on July 21, 2010. Consequently, hybrid capital such as trust preferred securities may no longer be included in a bank holding company's Tier 1 capital, subject to certain exceptions and phase-out periods:

- Depository institution holding companies with $15 billion or more in total consolidated assets and nonbank financial companies supervised by the Federal Reserve must phase out hybrid capital issued before May 19, 2010 from January 2013 to January 2016;

- Depository institution holding companies with less than $15 billion in total consolidated assets as of December 31, 2009 do not need to phase out hybrid capital issued before May 19, 2010;

- Intermediate U.S. holding companies of foreign banks have a five-year phase-out period for hybrid capital issued before May 19, 2010;

- Retroactive effect – capital instruments issued on or after May 19, 2010 are immediately subject to the regulatory capital deductions (*i.e.*, exclusion of hybrid capital) required by the Collins Amendment; and

- Certain small bank holding companies with less than $500 million in assets under the Federal Reserve's "Small Bank Holding Company Policy Statement"[594] and

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[594] See 12 C.F.R. 225, Appendix C.

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all federal home loan banks are exempt from this requirement, as are TARP preferred securities.

The capital requirements must also address systemic risks that the activities of the institutions pose arising from: significant volumes of activity in derivatives, securitized products, financial guarantees, securities borrowing and lending, and repurchase agreements; concentrations in assets for which values are based on models; and concentrations in market share for any activity that would substantially disrupt financial markets if forced to be unexpectedly ceased by the institution. The Dodd-Frank Act also requires that capital requirements for IDIs and bank and thrift holding companies be countercyclical so that the amount of required capital increases in times of economic expansion and decreases in times of economic contraction.

For banking organizations subject to the agencies' advanced approaches rules based on the Basel Committee's Basel II framework (the "advanced approaches"), a final rule was issued removing the transitional floors and establishing a permanent capital floor equal to the "generally applicable" risk-based capital requirements as defined in the Collins Amendment.[595] Currently the "generally applicable" risk-based requirements are the banking agencies' risk-based capital rules based on the Basel I accord (the "general capital rules"). A banking organization operating under the advanced approaches must therefore calculate capital ratios under both the general capital rules and the advanced approaches rules to determine whether it meets the minimum capital requirements. Agencies may amend the "generally applicable" capital requirements over time, and such amended requirements would serve as the new capital floor.

For bank holding companies with at least $50 billion in total consolidated assets and nonbank financial companies designated as systematically important (collectively, "SIFIs"), Section 165 of the Dodd-Frank Act mandates enhanced prudential standards for risk-based capital, leverage limits, and liquidity requirements, among other things. In addition, the Federal Reserve may establish other enhanced prudential standards including a contingent capital requirement. The enhanced requirements may be imposed by the Federal Reserve on its own initiative, or based on recommendations from the FSOC. In January 2012, the Federal Reserve published a proposed rule for enhanced risk-based capital requirements, leverage limits and liquidity requirements for SIFIs.[596] Under the proposal, all SIFIs would be required to submit an annual capital plan demonstrating their ability to maintain capital above existing minimum capital ratios and above a Tier 1 common ratio of 5% under expected and stressed conditions. The proposal also provides for enhanced liquidity requirements such as liquidity risk management standards, internal liquidity stress testing and liquidity buffers of highly liquid assets based on the Basel III liquidity rules.

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[595] 76 Fed. Reg. 37620 (Jun. 28, 2011).

[596] 77 Fed. Reg. 594 (Jan. 5, 2012).

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The Dodd-Frank Act precludes the use of rating agencies' credit ratings in measuring an institution's risk-weighted assets, in contrast to the Basel III's framework which relies on credit rating agencies' published ratings for determining the risk of securities. All federal agencies must therefore remove from their regulations references to, and reliance on, credit ratings. This difference may result in inconsistent capital requirements with countries implementing Basel III that continue to rely on rating agencies' ratings.[597]

BASEL III

As a result of the recent global financial crisis, the U.S. banking industry is faced not only with significant regulatory changes affecting banks under the Dodd-Frank Act, but also new reforms to international capital adequacy standards proposed under Basel III that will impact banks worldwide.

Brief History Leading Up to Basel III

In 1989, the U.S. federal banking agencies established risk-based capital rules for U.S. banks (the "general capital rules") based on the capital adequacy framework adopted by the Basel Committee on Banking Supervision (the "Basel Committee") in July 1988 ("Basel I").[598] The Basel Committee is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1974. Basel I detailed an agreed framework among the countries to apply common minimum capital standards to the banking industries in their respective nations. Under Basel I and the agencies' general capital rules, a bank's Tier 1 capital ratio (Tier 1 capital to total risk-weighted assets) should be at least 4% and total capital ratio (Tier 1 capital plus Tier 2 capital to total risk-weighted assets) should be at least 8%. Tier 1 capital is generally comprised of common stock, some types of preferred stock and disclosed reserves. Tier 2 capital is generally comprised of undisclosed reserves, general loan-loss reserves, hybrid capital instruments (including cumulative preferred shares) and subordinated term debt. Certain adjustments are made to the capital such as the deduction of goodwill from Tier 1 capital. At least half of the total capital must consist of Tier 1 capital. In order to calculate total risk-weighted assets, the general capital rules assign a bank's assets into one of four risk weight categories (0%, 20%, 50% and 100%) to reflect differences in credit risk. Basel I has been revised from time to time to incorporate new forms of acceptable capital and new types of risk-weighted assets. In 1996, Basel I was amended to require banks to hold capital to cover their exposure to market risks (the "Market Risk Amendment").[599] The U.S. agencies implemented market risk rules based on the Market Risk Amendment soon thereafter. In addition to implementing Basel I capital requirements, the U.S. agencies also require most banks to maintain a minimum leverage ratio (Tier 1 capital to average total assets) of 4%.

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[597] See Section 939A of the Dodd-Frank Act.

[598] Basel Committee, "International Convergence of Capital Measurement and Capital Standards" (July 1988).

[599] Basel Committee, "Amendment to the Capital Accord to incorporate market risks" (January 1996).

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In the years since Basel I, innovations in financial products and services and advances in risk measurement and management practices led to the Basel Committee's adoption of a more risk-sensitive capital adequacy framework known as "Basel II".[600] Basel II is comprised of three pillars: Pillar 1—minimum risk-based capital requirements; Pillar 2—supervisory review; and Pillar 3—market discipline through enhanced public disclosures. Basel II does not change the minimum required capital ratios. In addition to Tier 1 and Tier 2 capital, Basel II allows short-term subordinated debt with a minimum maturity of two years and certain restrictions on repayment to be recognized as Tier 3 capital. Tier 3 capital is limited to 250% of a bank's Tier 1 capital and is used to support exposure to market risk. Pillar 1 modifies the Basel I definition of risk-weighted assets by requiring a banking institution to calculate capital requirements for exposure to both credit risk and operational risk (and market risk for institutions with significant trading activity). Basel II provides several methodologies for assessing credit risk and operational risk. For credit risk, there are (1) the standardized approach (a modified Basel I framework which includes use of external credit ratings for assets) and (2) two internal ratings-based approaches which uses an institution's internal estimates of key risk parameters for exposures in combination with specified risk-based capital formulas: (a) the foundation IRB approach which uses risk parameters that are provided partly by supervisors and partly by the institutions and (b) the advanced IRB approach which allows institutions to provide all of the risk parameters. For operational risk, there are the basic indicator approach, the standardized approach and the advanced measurement approach. In December 2007, the U.S. federal bank regulators issued a final rule (the "Basel II Final Rule") for banks implementing the advanced IRB approach for credit risk and the advance measurement approach for operational risk (the "advanced approaches") under Basel II.[601] The Basel II Final Rule is mandatory for banking organizations with at least $250 billion in total consolidated assets or at least $10 billion in total consolidated on-balance sheet foreign exposure. Additional banks may voluntarily adopt the advanced approaches under the Basel II Final Rule if they meet qualifying criteria. Banks subject to the Basel II Final Rule must conduct three-year parallel runs which for some began in 2009. Banks that do not adopt the Basel II Final Rule remain subject to the general capital rules based on Basel I.

Overview of Basel III

Despite Basel II's objective towards a more risk sensitive regulatory capital framework, the recent global financial crisis revealed weaknesses in the existing capital requirements to adequately absorb losses incurred during the crisis. Concerned with the shortcomings of Basel II, the Basel Committee worked to develop a comprehensive reform package to address both firm-specific and broader, systemic risks within the global financial system. On December 16, 2010, the Basel Committee set out the details of its new Basel III

[600] Basel Committee, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (June 2006).

[601] 72 Fed. Reg. 69288 (Dec. 7, 2007).

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capital adequacy framework ("Basel III").[602] Some of the key Basel III reforms include increases to the quality and quantity of capital, introduction of additional capital buffers and a new leverage ratio, and setting of global liquidity standards.

Quality and Quantity of Capital

In contrast to Basel I and Basel II, Basel III breaks down Tier 1 capital into (1) common equity Tier 1 capital and (2) additional Tier 1 capital. Under Basel III, a new minimum common equity Tier 1 capital to risk-weighted assets ratio is set at 4.5%, and the minimum Tier 1 capital (common equity Tier 1 capital plus Additional Tier 1 capital) to risk-weighted assets ratio is increased to 6%. Minimum total capital (Tier 1 capital plus Tier 2 capital) remains unchanged at 8% of risk-weighted assets. These ratios would be fully phased in by January 2015. Basel III emphasizes that common equity should be the predominant form of Tier 1 capital, and generally consist of common stock meeting specific criteria, common stock surplus, retained earnings and other disclosed reserves, and minority interests in common stock of consolidated subsidiaries meeting certain criteria, minus regulatory deductions and adjustments. Additional Tier 1 generally consists of non-common equity instruments that meet specific criteria such as non-cumulative perpetual preferred stock, and certain minority interests not included in common equity Tier 1 capital, minus regulatory deductions and adjustments. Basel III imposes new regulatory deductions from and adjustments to Tier 1 capital to be phased in over a five-year period beginning January 1, 2014. Certain hybrid capital instruments, such as trust preferred securities, instruments with step-up clauses and cumulative perpetual preferred stock will be phased out of Tier 1 capital over ten years starting January 1, 2013. While Tier 1 capital is intended to absorb losses on a "going concern" basis, Tier 2 capital is intended to absorb losses on a "gone-concern" basis. Tier 2 capital generally consists of lower forms of equity meeting specific criteria including cumulative preferred stock, subordinated debt and certain loan loss provisions, minus regulatory deductions and adjustments. The distinctions between upper and lower Tier 2 instruments and the recognition of Tier 3 capital under the Basel II framework are abolished under Basel III.

The Basel Committee also issued additional criteria for Additional Tier 1 capital and Tier 2 capital of internationally active banks in a set of minimum requirements ("Loss Absorbency Rules") to ensure that such instruments are capable of absorbing losses at the point of non-viability. The Loss Absorbency Rules require that Additional Tier 1 capital and Tier 2 capital instruments include a feature that requires them to either be written off or converted into common equity upon the occurrence of a "trigger event" as determined by the relevant home country authority. An instrument would need to contractually incorporate the feature unless the laws of the governing jurisdiction of the bank require such Tier 1 and Tier 2 instruments to be written off upon such event or to otherwise fully absorb losses

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[602] Basel Committee, "Basel III: A global regulatory framework for more resilient banks and banking systems" (Dec. 2010, revised Jun. 2011) and "Basel III: International framework for liquidity risk measurement, standards and monitoring" (Dec. 2010).

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before taxpayers are exposed to loss, and this requirement is disclosed in the offering documents.[603]

Capital Buffers and Leverage Ratio

In addition to the minimum capital ratios, Basel III introduces a capital conservation buffer and a countercyclical capital buffer for banks to act as an additional capital "cushion" that can be drawn down in times of financial stress. The capital conservation buffer requires banks to hold an additional 2.5% of common equity Tier 1 capital to risk-weighted assets. As the buffer falls below 2.5%, banks would be subject to increasing restrictions on capital distributions such as dividends, share buybacks and discretionary bonuses based on a sliding scale. The countercyclical capital buffer would act as an extension of the capital conservation buffer, and applied only during periods of excess credit growth leading to the build up of system-wide risk. Basel III relies on each nation to set the countercyclical capital buffer for banks in its jurisdiction ranging from 0 to 2.5%. Any countercyclical capital buffer that is imposed would be announced up to twelve months in advance. Moreover, the Basel Committee determined that certain global systemically important banks ("G-SIBs") should be subject to an additional common equity Tier 1 capital surcharge (the "G-SIB surcharge").[604] The amount of the surcharge depends on a G-SIB's allocation into one of five buckets ranging from 1% to 3.5% based on a scoring system to determine systemic importance. Initially, the 3.5% bucket will be empty. The capital buffers and surcharge would be phased in from January 2016 to January 2019.

Basel III also introduces a minimum leverage ratio (Tier 1 capital to total exposure) of 3% to prevent the build-up of excessive leverage by banks. Although the leverage ratio is new under the Basel framework, U.S. banks are already subject to a minimum leverage ratio of 4% (3% for very well-rated banks, although this reduced requirement has been eliminated under the U.S. proposed rules implementing Basel III). Total exposure is the sum of on-balance sheet assets and certain off-balance sheet items. The leverage ratio would become fully effective in January 2018, with a parallel run period from 2013 to 2017.

Liquidity Standards

Although strong capital requirements are essential for banking sector stability, the Basel Committee has also acknowledged the importance of strengthening liquidity standards. As a result, the Basel Committee published its "Principles for Sound Liquidity Risk Management and Supervision" in 2008, and introduced harmonized global liquidity standards under Basel III. Basel III proposes two minimum liquidity ratios: a liquidity coverage ratio ("LCR") and a net stable funding ratio ("NSFR"). The LCR is intended to ensure that banks have sufficient unencumbered high-quality liquid assets to offset net cash

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[603] Basel Committee, "Final elements of the reforms to raise the quality of regulatory capital" (Jan. 2011).

[604] Basel Committee, "Global systemically important banks: assessment methodology and the additional loss absorbency requirement" (Nov. 2011).

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outflows encountered under an acute short-term stress scenario. Specifically, the LCR is defined as the ratio of high-quality liquid assets to total net cash outflows over the next thirty calendar days, and must be equal to or greater than 100%. High-quality liquid assets are divided into Level 1 and Level 2 assets. Level 1 assets such as cash, central bank reserves that can be drawn down in times of stress and certain marketable securities representing claims on sovereigns, public-sector entities or central banks can be included without limit. Level 2 assets such as certain corporate bonds and covered bonds are subject to a 15% haircut and may comprise up to 40% of the overall stock of high-quality liquid assets. Originally, the LCR was to be fully implemented by January 1, 2015. However, in recent amendments published by the Basel Committee, the minimum LCR would now be 60% implemented by January 1, 2015 and gradually increased over the next four years in 10% increments until fully implemented by January 1, 2019. Other amendments to the LCR include a new category of high-quality liquid assets called Level 2B assets which are lower rated assets than Level 2A assets (formerly Level 2 assets under the original LCR standards), reduction in the outflow assumptions for several sources of funding including the assumed drawdown rates on the unused portion of certain committed liquidity and credit facilities, refinement and clarification of the operational requirements applicable to high-quality liquid assets, and a reaffirmation that banks could use their stock of high-quality liquid assets in periods of stress such that the LCR falls below 100%.[605] The NSFR is designed to promote longer term funding for bank assets and activities over a one-year time horizon under conditions of extended stress. The NSFR is defined as the ratio of available amount of stable funding ("ASF") to required amount of stable funding ("RSF"), and must exceed 100%. ASF equals the total amount of a bank's regulatory capital, along with preferred stock with maturity of one year or more, liabilities with maturities of one year or more, and the portion of non-maturity deposits and term deposits, and wholesale funding with maturities of less than one year that would be expected to stay with the institution for an extended period in an idiosyncratic stress event. RSF is calculated as the sum of the value of the assets held and funded by the bank, multiplied by a specific RSF factor assigned to each particular asset type, and the amount of off-balance sheet activity (or potential liquidity exposure) multiplied by its RSF factor. The RSF factor applied to each asset or off-balance sheet exposure is the amount of that item that supervisors believe should be supported with stable funding. The NSFR would be fully implemented by January 1, 2018. In addition to the liquidity ratios, Basel III includes a set of metrics to be used as "monitoring tools" to capture specific information related to a bank's cash flows, balance sheet structure, available unencumbered collateral and certain market indicators. These metrics, along with the liquidity ratios, are intended to assist national regulators in assessing a bank's liquidity risk.

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[605] See "Group of Governors and Heads of Supervision Endorses Revised Liquidity Standard for Banks" (Jan. 6, 2013) available at http://www.bis.org/press/p130106.htm and Basel Committee, "Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools" (Jan. 2013).

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U.S. Implementation of Basel III

Basel III will need to be implemented by the regulatory authorities of member countries by statute or regulation. U.S. regulators are thus faced with the task of harmonizing the Basel III capital reforms with the Dodd-Frank Act regulatory capital requirements to develop an integrated regulatory capital framework for U.S. banking organizations.

In June 2012, the Federal Reserve, the OCC, and the FDIC (the "agencies") released three proposed rules ("NPRs") and one final rule ("Market Risk Final Rule") that would substantially revise the current regulatory capital rules for U.S. federal and state-chartered banks and savings associations, U.S. bank holding companies with at least $500 million in total consolidated assets, and U.S. savings and loan holding companies regardless of asset size (collectively, "Banking Organizations"). These new rules are intended to implement the regulatory capital reforms recommended under Basel III and those required under the Dodd-Frank Act, as well as revisions to the market risk capital rules made by the Basel Committee. Comments on the NPRs were due by October 22, 2012 and, although the NPRs contemplate an effective date of January 1, 2013, this date has since been pushed back as the rules have not been finalized. The Market Risk Final Rule became effective on January 1, 2013. Consequently, this delay may affect the phase-in of certain Basel III standards, especially those that were proposed in the NPRs to begin in 2013.

The three NPRs consist of:

- "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action" (the "Basel III NPR");[606]

- "Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements" (the "Standardized Approach NPR");[607] and

- "Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule" (the "Advanced Approaches NPR").[608]

The Basel III NPR

The Basel III NPR would apply to all Banking Organizations. This NPR would revise the minimum risk-based and leverage capital requirements and the definition of

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[606] 77 Fed.Reg. 52792 (Aug. 30, 2012).

[607] 77 Fed.Reg. 52888 (Aug. 30, 2012).

[608] 77 Fed.Reg. 52978 (Aug. 30, 2012).

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capital, introduce new capital conservation and countercyclical capital buffers, and incorporate the new regulatory capital minimums and definitions into the agencies' prompt corrective action ("PCA") framework.

Minimum Capital and Leverage Ratios

Consistent with Basel III, the Basel III NPR proposes the following minimum risk-based capital ratios to be phased in from January 1, 2013 to January 1, 2015:

- a new common equity Tier 1 capital to total risk-weighted assets ratio of 4.5%;
- an increase in the Tier 1 capital to total risk-weighted assets ratio from 4% to 6%; and
- a total capital to total risk-weighted assets ratio of 8% (unchanged from current requirements).

The minimum leverage ratio (Tier 1 capital to average total on-balance sheet assets) would remain at 4% for all Banking Organizations without exception. The existing 3% leverage ratio exception for banking organizations with a supervisory composite rating of 1 would effectively be eliminated. In addition, Banking Organizations that are subject to the agencies' Basel II advanced approaches rules ("Advanced Approaches Banking Organizations") would be required to maintain a supplementary leverage ratio of Tier 1 capital to total leverage exposure of 3% beginning in 2018. The supplementary leverage ratio would include on-balance sheet assets and certain off-balance sheet exposures in the denominator. Advanced Approaches Banking Organizations would be required to calculate and report their supplementary leverage ratio beginning on January 1, 2015.

Capital Conservation and Countercyclical Capital Buffers

In addition to the minimum risk-based capital ratios, all Banking Organizations would be required to maintain a capital conservation buffer consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets to be phased in starting on January 1, 2016. A Banking Organization's capital conservation buffer would be the lowest of the following measures: (i) its common equity Tier 1 capital ratio minus its minimum common equity Tier 1 capital ratio; (ii) its Tier 1 capital ratio minus its minimum Tier 1 capital ratio; and (iii) its total capital ratio minus its minimum total capital ratio. In addition to the capital conservation buffer, Advanced Approaches Banking Organizations would be required to maintain a countercyclical capital buffer of up to 2.5% of common equity Tier 1 capital if the agencies determine that the market is experiencing excess capital growth. The countercyclical capital buffer in the United States would initially be set to zero and if imposed, would serve as an extension of the capital conservation buffer. The countercyclical capital buffer could be phased in starting in 2016. Table 1 attached hereto illustrates the phase-in schedule for the minimum capital ratios and capital buffers.

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To the extent that a Banking Organization fails to maintain a capital conservation buffer of 2.5% (plus, for an Advanced Approaches Banking Organization, 100% of any applicable countercyclical capital buffer amount), capital distributions (including dividend payments, discretionary payments on Tier 1 instruments, and share buybacks) and certain discretionary bonus payments to executives, will become increasingly limited as the capital conservation buffer decreases. As indicated in the table below, the maximum payout ratio would be the percentage of eligible retained income that a banking organization is permitted to pay out in the form of capital distributions and certain discretionary bonus payments during the current calendar quarter. Eligible retained income is net income (as reported in the Banking Organization's quarterly regulatory reports) for the four calendar quarters preceding the current calendar quarter, net of any capital distributions, certain discretionary bonus payments, and associated tax effects not already reflected in net income.

Capital Conservation Buffer (as a percentage of total risk-weighted assets)	**Maximum Payout Ratio (as a percentage of eligible retained income)**
Greater than 2.5%	No payout limitation applies
Less than or equal to 2.5% and greater than 1.875%	60%
Less than or equal to 1.875% and greater than 1.25%	40%
Less than or equal to 1.25% and greater than 0.625%	20%
Less than or equal to 0.625%	0%

Since the capital buffers are in addition to the regulatory minimum requirements, the restrictions on capital distributions and discretionary bonus payments would not give rise to any applicable restrictions under the agencies' PCA framework.

Definition of Capital

Consistent with Basel III, the Basel III NPR revises the definition of capital to include common equity Tier 1 capital, Additional Tier 1 capital, and Tier 2 capital. Tier 1 capital consists of common equity Tier 1 capital plus Additional Tier 1 capital. Common equity Tier 1 capital would include common stock meeting certain criteria, retained earnings, accumulated other comprehensive income and a limited amount of common equity minority interests, minus regulatory deductions and adjustments. Additional Tier 1 capital would include equity capital instruments that meet specific criteria, a limited amount of Tier 1 minority interests, and instruments that currently qualify as Tier 1 capital under the agencies' general risk-based capital rules that were issued under the Small Business Jobs Act of 2010, or, prior to October 4, 2010, under the Emergency Economic Stabilization Act of 2008, minus regulatory deductions and adjustments. Non-cumulative perpetual preferred stock would continue to qualify as Additional Tier 1. However, cumulative perpetual preferred stock and trust preferred securities would no longer qualify as Tier 1. Total capital consists of Tier 1 capital plus Tier 2 capital. Tier 2 capital would generally include capital instruments that meet certain criteria including subordinated debt, a limited amount of total capital minority interests and allowance for loan and lease losses, and instruments that currently qualify as Tier 2 capital under the agencies' general risk-based capital rules that

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were issued under the Small Business Jobs Act of 2010, or, prior to October 4, 2010, under the Emergency Economic Stabilization Act of 2008, minus regulatory deductions and adjustments. Trust preferred securities and cumulative perpetual preferred stock could qualify as Tier 2 capital if such instruments meet the eligibility criteria. The agencies also address the Loss Absorbency Rules under Basel III. For an Advanced Approaches Banking Organization, the eligibility criteria for Additional Tier 1 and Tier 2 instruments require that the governing agreement, offering circular or prospectus of the instrument issued after January 1, 2013 must disclose that the holders of the instrument may be fully subordinated to interests held by the U.S. government in the event that the banking organization enters into a receivership, insolvency, liquidation, or similar proceeding. According to the agencies, U.S. law is generally consistent with the Basel III loss absorbency at the point of non-viability standard, based on the Dodd-Frank Act's Title II orderly liquidation authority, Section 11 of the Federal Deposit Insurance Act and U.S. bankruptcy law.

Non-qualifying capital instruments would be phased out from regulatory capital. Depository institution holding companies with $15 billion or more in total consolidated assets would be required to phase out non-qualifying capital instruments issued before May 19, 2010 over a three-year period from 2013 to 2016. Depository institution holding companies with less than $15 billion in total consolidated assets would be required to phase out non-qualifying capital instruments issued before September 10, 2010 from 2013 to 2022.

Proposed regulatory deductions from, and adjustments to, capital are generally stricter in the Basel III NPR than under the agencies' current regulatory capital rules, including with respect to goodwill and other intangible assets, mortgage servicing assets, deferred tax assets, gain-on-sale associated with a securitization exposure, unrealized gains and losses on certain cash flow hedges, and investments in the capital of unconsolidated financial institutions over certain thresholds. Most deductions and adjustments would be applied to common equity Tier 1 capital.

Revisions to the Prompt Corrective Action ("PCA") Framework

The PCA framework consists of five regulatory capital categories applicable to insured depository institutions: (1) "well capitalized," (2) "adequately capitalized," (3) "undercapitalized," (4) "significantly undercapitalized," and (5) "critically undercapitalized." Insured depository institutions that fail to meet these capital measures are subject to increasingly strict limits on their activities, including their ability to make capital distributions, pay management fees, grow their balance sheet, and take other actions.

The Basel III NPR would update the PCA framework to reflect the proposed revisions to the definition of capital and the revised minimum regulatory capital ratios. For example, an "adequately-capitalized" institution would need to maintain a minimum common equity Tier 1 capital ratio of 4.5%, Tier 1 capital ratio of 6%, total capital ratio of 8% and leverage ratio of 4%. A "well-capitalized" institution would need to maintain a minimum common equity Tier 1 capital ratio of 6.5%, Tier 1 capital ratio of 8%, total capital ratio of 10% and leverage ratio of 5%. The proposed supplementary leverage ratio of 3% for Advanced Approaches Banking Organizations would also be incorporated into the

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framework. These revisions would take effect starting on January 1, 2015 when the minimum regulatory capital ratios are fully phased in.

Standardized Approach NPR

The Standardized Approach NPR would apply to all Banking Organizations. This NPR proposes changes to the agencies' general capital rules for determining risk-weighted assets (*i.e.*, the denominator of the risk-based capital ratios) by adopting additional risk weight categories and incorporating certain aspects of the Basel II standardized approach to enhance risk sensitivity. In addition, risk-weighted assets would be calculated using alternatives to credit ratings in accordance with Section 939A of the Dodd-Frank Act. The Standardized Approach NPR is proposed to take effect on January 1, 2015, with an option for early adoption.

A Banking Organization would determine its standardized total risk-weighted assets by calculating the sum of: (i) its risk-weighted assets for general credit risk, off-balance sheet items, OTC derivative contracts, cleared transactions, unsettled transactions, securitization exposures, and equity exposures (as defined in the Standardized Approach NPR) plus (ii) risk-weighted assets for market risk under the market risk rules, if applicable, less (iii) allowance for loan and lease losses ("ALLL") that is not included in Tier 2 capital. Whereas the agencies' general capital rules use four risk weight categories (0%, 20%, 50% and 100%), the Standardized Approach NPR adopts a larger number of risk weight categories and introduces a more risk-sensitive treatment for certain types of exposures. Some of the key provisions of the Standardized Approach NPR include:

- *U.S. Government, public sector entities and depository institutions*. Risk weights for credit exposures to U.S. government and agencies (0%), U.S. government-sponsored entities (20%), U.S. public sector entities such as states and municipalities (20%) and U.S. depository institutions (20%) remain unchanged from the general capital rules.

- *Foreign sovereigns, public sector entities and banks.* Risk weights for credit exposures to foreign governments, foreign public sector entities, and foreign banks are based on the Country Risk Classification ("CRC") measure produced by the Organization for Economic Co-operation and Development ("OECD") and range from 0% to 150%.

- *Corporate exposures.* Corporate exposures are assigned a risk weight of 100%, including exposures to securities firms.

- *Residential mortgage exposures.* Residential mortgage exposures are subject to a wider range of risk weights from 35% to 200% based on certain criteria such as loan characteristics and loan-to-value ratios.

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- *Commercial real estate.* Certain commercial real estate exposures that receive a 100% risk weight under the general capital rules, would be assigned a 150% risk weight if they are high volatility commercial real estate exposures.

- *Past due exposures.* Exposures that are not guaranteed or secured, and are more than ninety days past due or on nonaccrual (excluding sovereign exposures or residential mortgage exposures) are assigned a 150% risk weight.

- *Equity exposures.* Risk weights for equity exposures depend on the type of issuer and other factors. A Banking Organization would be required to apply the simple risk-weight approach ("SRWA") with risk weights ranging from 0% to 600% for equity exposures that are not exposures to an investment fund and apply certain look-through approaches to assign risk-weighted asset amounts to equity exposures to an investment fund.

- *Off-balance sheet items.* Similar to the general capital rules, the NPR would require the exposure amount of an off-balance sheet item to be calculated by applying a credit conversion factor ("CCF") ranging from 0% to 100%. The NPR, however, increases the CCF for commitments with an original maturity of one year or less from 0% to 20%.

- *OTC derivative contracts.* A Banking Organization would determine the exposure amount (sum of current exposure plus potential future credit exposure ("PFE")) of the OTC derivative contract and then assign a risk weight based on the counterparty or collateral. In contrast to the general capital rules, which place a 50% risk weight cap on derivatives, the NPR does not include a risk weight cap and introduces a revised conversion factor matrix for calculating PFE.

- *Cleared transactions.* The NPR provides preferential capital requirements for cleared derivative and repo-style transactions with central counterparties that meet specific standards. A clearing member of a qualifying central counterparty is required to calculate a risk-weighted asset amount for its default fund contributions to the central counterparty.

- *Securitization exposures.* Risk weights for securitization exposures would be calculated using either: (1) for banks not subject to the market risk rules, a gross-up approach that assigns risk-weights based on the full amount of the credit-enhanced assets for which the Banking Organization assumes credit risk, and the level of subordination of the securitization exposure as provided under the general capital rules or (2) a simplified supervisory formula approach ("SSFA") based on the underlying assets and exposure's relative position in the securitization's structure. For each approach, the minimum risk weight would be 20%. Alternatively, banks can opt to apply a 1,250% risk weight to securitization exposures, with certain exceptions related to asset-backed commercial paper.

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- *Credit risk mitigation.* The NPR recognizes a wider range of eligible collateral and eligible guarantors for credit risk mitigation.

- *Disclosure requirements.* Banking organizations with total consolidated assets of $50 billion or more that are not Advanced Approaches Banking Organizations would be subject to qualitative and quantitative disclosure requirements on a quarterly, and in some cases, annual basis.

Advanced Approaches NPR

The Advanced Approaches NPR would apply to Advanced Approaches Banking Organizations (*i.e.*, Banking Organizations with at least $250 billion in total consolidated assets or at least $10 billion in total consolidated on-balance sheet foreign exposure). Additionally, the NPR would apply the advanced approaches and Market Risk Final Rule to savings associations and savings and loan holding companies that meet stated thresholds for trading activity. Under this NPR, the agencies propose to revise their existing Basel II advanced approaches rules to be consistent with Basel III and Section 939A of the Dodd-Frank Act. The Advanced Approaches NPR does not include a proposed effective date.

Some of the key provisions in the Advanced Approaches NPR include:

- *Counterparty credit risk.* The NPR would propose counterparty credit risk revisions that are generally consistent with Basel III, but modified to incorporate alternative standards to the use of credit ratings.

  - *Recognition of financial collateral.* Under the NPR, resecuritizations, conforming residential mortgages, and debt securities that are not investment grade, would no longer qualify as eligible financial collateral. As a result, a banking organization would not be able to recognize the credit risk mitigation benefits of such instruments through an adjustment to the exposure-at-default ("EAD"). In addition, new standardized supervisory haircuts would be imposed for securitization exposures in calculating EAD using a non-ratings-based approach.

  - *Changes to the Internal Models Methodology ("IMM").* The NPR would require that capital requirements for IMM exposures be equal to the larger of the capital requirement for those exposures calculated using (1) data from the most recent three-year period and (2) data from a three-year period that contain a period of stress reflected in the credit default spreads of the bank's counterparties. An IMM exposure would be defined as a repo-style transaction, eligible margin loan, or OTC derivative for which a bank calculates its EAD using the IMM.

  - *Recognition of wrong-way risk.* The NPR proposes enhancements that would require banking organizations' risk management procedures to identify, monitor, and control wrong-way risk throughout the life of an exposure.

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Wrong-way risk would be defined as the risk that arises when an exposure to a particular counterparty is positively correlated with the probability of default of such counterparty itself.

- *Changes to holding periods and the margin period of risk.* The NPR proposes increases to the assumed holding period in the collateral haircut and simple VaR approaches, and to the margin period of risk in the IMM that a banking organization may use to determine its capital requirement for repo-style transactions, OTC derivative transactions, or eligible margin loans.

- *Credit valuation adjustments.* CVA is the fair value adjustment to reflect counterparty credit risk in the valuation of an OTC derivative contract. The NPR would require banking organizations to calculate its CVA capital requirement using one of two approaches. To convert the CVA capital requirement to a risk-weighted asset amount, a banking organization would multiply its CVA capital requirement by 12.5.

- *Treatment of securitization exposures.* Consistent with the 2009 Basel II Enhancements, the NPR proposes to strengthen the risk-based capital requirements for certain securitization exposures by requiring Advanced Approaches Banking Organizations to conduct more rigorous credit analysis of securitization exposures and enhancing the disclosure requirements related to such exposures.[609] The ratings-based approach and the internal assessment approach for securitization exposures from the existing advanced approaches rules would be replaced with either the supervisory formula approach ("SFA") or a simplified version of the SFA when calculating capital requirements for securitization exposures.

- *Disclosure requirements.* Banking organizations would be subject to qualitative and quantitative disclosure requirements on a quarterly, or in some cases, annual basis, including enhanced disclosures for securitizations.

Collins Amendment Floor

The Basel III NPR and the Standardized Approach NPR are proposed to become the revised "generally applicable" capital requirements for purposes of the Collins Amendment, and would become the minimum capital floor. If adopted, the Advanced Approaches Banking Organizations would need to calculate their capital ratios under both the revised "generally applicable" capital requirements and the revised advanced approaches rules (as proposed by the Advanced Approaches NPR) to determine whether they meet the minimum capital requirements.

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[609] Basel Committee, "Enhancements to the Basel II framework" (July 2009).

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Liquidity Standards and G-SIB Surcharge Not Addressed in the NPRs

The NPRs do not implement the Basel III liquidity standards (*i.e.*, the Liquidity Coverage Ratio ("LCR") and Net Stable Funding Ratio ("NSFR")) and the Basel Committee's common equity Tier 1 capital surcharge for global systemically important banks ("G-SIB surcharge"). However, the agencies have indicated their intent to propose rules to implement some version of the Basel III liquidity standards in the United States through separate rulemakings. Such rules would need to be incorporated into the enhanced liquidity standards applicable to large U.S. and foreign banking organizations under Section 165 of the Dodd-Frank Act. Pursuant to Section 165 of the Dodd-Frank Act, the Federal Reserve intends to propose a capital surcharge for SIFIs or a subset of SIFIs, based on the G-SIB surcharge. The SIFI surcharge would be phased in from 2016 to 2019.[610]

Market Risk Final Rule

The Market Risk Final Rule, titled "Risk-Based Capital Guidelines: Market Risk," implements revisions to the agencies' market risk capital rules based on amendments to the Basel Committee's market risk framework between 2005 and 2010 ("Basel II.5") and became effective on January 1, 2013.[611] Under the rule, Banking Organizations that have aggregated trading assets and liabilities of at least $1 billion or 10% of total assets ("Market Risk Banking Organizations") are required to adjust their capital requirements to better account for the market risks in their trading activities.[612] To comply with Section 939A of the Dodd-Frank Act, the rule does not include aspects of Basel II.5 that rely on credit ratings, but uses alternative standards of creditworthiness for determining specific risk capital requirements for certain debt and securitization positions.

A Market Risk Banking Organization would calculate its total risk-weighted assets (*i.e.*, the denominator of the risk-based capital ratios) as the sum of its adjusted risk-weighted assets calculated under the applicable risk-based capital rules, and its market risk equivalent assets calculated under the market risk rules. To calculate general market risk equivalent assets, a bank would multiply its general measure for market risk by 12.5. A bank subject to the advanced approaches rules would also calculate its advanced market risk equivalent assets by multiplying its advanced measure for market risk by 12.5. A bank's general and advanced measures for market risk equal the sum of its VaR-based capital requirement, its stressed VaR-based capital requirement, specific risk add-ons, incremental risk capital requirement, comprehensive risk capital requirement, and capital requirement for *de minimis* exposures, each calculated according to the Market Risk Final Rule. In addition, the Market Risk Final Rule:

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[610] See 77 Fed. Reg. 594, 599 (Jan. 5, 2012).

[611] See 77 Fed. Reg. 53060 (Aug. 30, 2012).

[612] In the Advanced Approaches NPR, the agencies proposed to apply the Market Risk Final Rule to savings associations and savings and loan holding companies that meet certain thresholds for trading activity.

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- modifies the definition of "covered position" to include certain reported trading assets or trading liabilities that are trading positions (*i.e.*, held for the purpose of short-term resale, to lock in arbitrage profits, to benefit from actual or expected short-term price movements, or to hedge covered positions) and foreign exchange and commodity positions;

- requires banks to adopt (1) clearly defined policies and procedures for identifying the scope of trading positions, including consideration of the extent to which a position or its hedge can be marked to market daily by reference to a two-way market and possible impairments to the liquidity of a position or its hedge, (2) clearly defined trading and hedging strategies that are approved by senior management and (3) policies and procedures for actively managing all of their covered positions;

- requires banks to receive prior written approval from their primary federal supervisor before using internal models to calculate their market risk capital requirements;

- requires banks to use internal modeling to calculate daily VaR-based measures that reflect general market risk for covered positions and certain specific risks, and a weekly stressed VaR-based measure;

- applies standardized specific risk weighting factors for sovereign debt positions, exposures to certain supranational entities and multilateral development banks, exposures to government-sponsored entities, and corporate debt positions;

- requires banks to use a simplified supervisory formula approach (SSFA) to assign specific risk weighting factors to securitization positions subject to a 20% floor, or alternatively, to assign a specific risk weighting factor of 100% to securitization positions (equivalent to a 1,250% risk weight); and

- includes disclosure requirements designed to increase transparency and improve market discipline, including a description of the components of a bank's market risk capital requirements, modeling approaches, and securitization activities.

MONEY LAUNDERING AND TERRORIST FINANCING

Anti-Money Laundering

The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("USA PATRIOT Act") is a broad anti-money laundering and anti-terrorism law that provides for an array of measures aimed at increasing national security, improving surveillance of terrorist activities, easing information sharing

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and combating money laundering.[613] Title III of the USA PATRIOT Act contains significant compliance requirements for financial institutions with respect to the detection and prevention of money laundering. The provisions of Title III also amend portions of the Bank Secrecy Act of 1970 ("Bank Secrecy Act").[614]

The definition of "financial institution" in the USA PATRIOT Act is taken from the Bank Secrecy Act and includes, among other entities, (a) an insured bank; (b) a commercial bank or trust company; (c) a private banker; (d) an agency or branch of a non-U.S. bank operating in the United States; (e) a thrift institution; (f) a broker-dealer in securities or commodities; (g) an investment company; (h) an insurance company; (i) a loan finance company; and (j) a registered futures commission merchant, commodity trading advisor or commodity pool operator.[615] Regulations implementing provisions of the USA PATRIOT Act may apply only to "covered financial institutions," a term meant to define a smaller subset of financial institutions. The subset of "covered financial institutions" vary depending on the regulation, but often include banks, registered broker-dealers, branches and agencies of non-U.S. banks, mutual funds, trust companies, money services businesses, insurance companies, registered futures commission merchants and introducing brokers in commodities. Various government agencies take part in issuing and enforcing anti-money laundering regulations and rules, providing supervisory guidance, and/or examining financial institutions for compliance, including the Treasury Department's Financial Crimes Enforcement Network ("FinCEN") and functional regulators such as the federal banking agencies. In addition, certain self-regulatory organizations such as FINRA also promulgate rules and examine compliance by its members.

The USA PATRIOT Act requires covered financial institutions that operate in the United States to implement a written, risk-based anti-money laundering program ("AML Program") that includes, at a minimum: (i) internal policies, procedures and controls reasonably designed to guard against money laundering; (ii) designation of a compliance officer to oversee the implementation and enforcement of anti-money laundering policies and procedures; (iii) ongoing employee training in the prevention and detection of money laundering; and (iv) adoption of an independent audit program to test the effectiveness of the AML program and the financial institution's overall compliance. The anti-money laundering obligations of financial institutions subject to the USA PATRIOT Act, the Bank Secrecy Act and their implementing regulations are extensive. As part of their AML Program, covered financial institutions must identify and verify the identity of customers and perform know-your-customer due diligence. Special and enhanced due diligence measures should be applied to certain customers that present heightened AML risks, non-U.S. financial

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[613] The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Publ. L. No. 107-56 (2001).

[614] Bank Secrecy Act, Pub. L. 91-508 (1970), codified at 12 U.S.C. 1829b, 12 U.S.C. 1951-1959, and 31 U.S.C. 5311-5314; 5316-5332.

[615] 31 U.S.C. 5312(a)(2) and (c).

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institutions, and senior foreign political figures who hold private banking accounts in the United States. Upon FinCEN's request, financial institutions must search their records for accounts or transactions with persons suspected of engaging in money laundering or terrorist activity, and report any matches. From time to time, the Secretary of the Treasury requires financial institutions to take certain special measures against foreign jurisdictions, foreign financial institutions, classes of international transactions, or types of accounts of primary money laundering concern. The AML Program must also include procedures and systems to effectively monitor, detect, review and report unusual or suspicious activity that could potentially involve money laundering, terrorist financing and other criminal activity. Financial institutions must also comply with various reporting and recordkeeping requirements, such as the reporting of currency transactions, foreign financial accounts and suspicious activity and the recordkeeping of fund transfers.

More, recently, FinCEN has focused attention on requirements for financial institutions to obtain and retain beneficial ownership information as part of customer due diligence. In March 2010, FinCEN, the bank regulators and the SEC, after consulting with the CFTC, issued joint guidance to clarify existing U.S. regulatory expectations for obtaining beneficial ownership information for certain accounts and customer relationships. The guidance noted that financial institutions should establish and maintain customer due diligence procedures that are reasonably designed to identify and verify the identity of beneficial owners of an account based on the institution's evaluation of risk pertaining to an account. Examples of customers that may pose heightened risks include certain trusts, corporate entities, shell entities and private investment companies.[616] However, the issue of whether obtaining beneficial ownership information should become a mandatory requirement came under consideration. In March 2012, FinCEN, after consulting with various federal supervisory authorities, published an advanced proposed rule seeking public comment on the establishment of a categorical customer due diligence obligation for financial institutions to identify beneficial ownership of their accountholders and a proposed new definition of beneficial ownership.[617] As part of its request, FinCEN also sought comments on the difficulties of identifying beneficial owners presented by certain types of accounts, such omnibus and other intermediated accounts. The proposed rule would be applicable to banks, brokers or dealers in securities, mutual funds and futures commission merchants.

OFAC Compliance

OFAC administers and enforces economic and trade sanctions against targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction. Many of the sanctions are based on United Nations and other international mandates, whereas others are specific to the

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[616] Guidance on Obtaining and Retaining Beneficial Ownership Information (March 5, 2010), available at: http://www.fincen.gov/statutes_regs/guidance/pdf/fin-2010-g001.pdf.

[617] 77 Fed. Reg. 13046 (Mar. 5, 2012).

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interests of the United States. The sanctions generally require that accounts and other assets of targeted individuals, entities or countries be blocked, or that certain trade and financial transactions with targeted individuals, entities or countries are prohibited or must be rejected, unless a license is granted by OFAC.

All U.S. persons must comply with OFAC sanctions, including all U.S. citizens and permanent resident aliens wherever they are located, and U.S. banks, bank holding companies and nonbank subsidiaries. Banks are expected to establish and maintain an effective, written OFAC compliance program that is commensurate with their OFAC risks. Banks must screen customers against the OFAC list of “Specially Designated Nationals and Blocked Persons” and identify accounts or transactions involving OFAC sanctioned countries to prevent potential OFAC violations. If a valid match is discovered, any blocked property or rejected transaction must be reported to OFAC. Failure to comply with OFAC sanctions can result in severe criminal penalties in the form of fines and imprisonment, or civil penalties depending on the particular sanction program.

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TABLE 1 OF APPENDIX E

The new minimum capital ratios and other changes would be phased-in over time, as set forth in the table below:

Year (as of Jan.1)	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Minimum common equity Tier 1 ratio	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Common equity Tier 1 capital conservation buffer	-	-	-	0.625%	1.25%	1.875%	2.50%
Common equity Tier 1 plus capital conservation buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from common equity Tier 1 (including threshold deduction items that are over the limits)	-	20%	40%	60%	80%	100%	100%
Minimum Tier 1 capital	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Tier 1 capital plus capital conservation buffer	4.5%	5.5%	6.0%	6.625%	7.25%	7.875%	8.5%
Minimum total capital	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum total capital plus capital conservation buffer	8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Maximum potential countercyclical capital buffer	-	-	-	0.625%	1.25%	1.875%	2.5%
Supplementary leverage ratio (applicable only to advanced approaches banking organizations)	-	-	Must calculate and report ratio, but no minimum	Must calculate and report ratio, but no minimum	Must calculate and report ratio, but no minimum	3.0%	3.0%

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APPENDIX F

FORM 8-K DISCLOSURE REQUIREMENTS CHART

APPENDIX F

FORM 8-K DISCLOSURE REQUIREMENTS CHART

Event	Form 8-K Disclosure Item	Filing Deadline
Entry into, assumption of, material amendment of, or material early termination of, any material contract, not made in the ordinary course of business. This would ordinarily include: • Merger or Purchase Agreements • Credit Agreements • Underwriting, Subscription, or Purchase Agreements regarding the issuance of securities • Stockholder Rights Agreements	*Item 1.01 – Entry into a Material Definitive Agreement, or Item 1.02 – Termination of a Material Definitive Agreement*	Four business days after execution
Entry into, assumption of, material amendment of, or material early termination of, the following contracts, even if made in the ordinary course of business: • Contracts with corporate insiders or affiliates (excluding agreements relating to executive compensation, which are separately addressed under Item 5.02) • Contracts on which the company's business is substantially dependant (such as key customer or supplier agreements and key intellectual property licenses or agreements) • Contracts for the acquisition or sale of assets for a price greater than 15% of the company's consolidated total fixed assets • Material leases	*Item 1.01 – Entry into a Material Definitive Agreement, Instruction 1, referencing Regulation S-K, Item 601(b)(10)(ii)(A)-(D), or Item 1.02 – Termination of a Material Definitive Agreement*	Four business days after execution

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Event	Form 8-K Disclosure Item	Filing Deadline
Public offering of equity securities or units	*Item 1.01*[618] *– Entry into a Material Definitive Agreement, as to the Underwriting or other Purchase Agreement* *If the offering is not material, companies sometimes make a voluntary report under Item 8.01 – Other Events.*	Four business days after entry into the Underwriting or Purchase Agreement
Private offering of equity securities or units	*Item 1.01*[619] *– Entry into a Material Definitive Agreement, as to any Underwriting or other Purchase Agreement* *Item 3.02 – Unregistered Sales of Equity Securities* *If the offering is not material, companies sometimes make a voluntary report under Item 8.01 – Other Events.*	Four business days after entry into the Underwriting or Purchase Agreement
Public offering of convertible debt securities	*Item 1.01*[620] *– Entry into a Material Definitive Agreement, as to any Indenture, Underwriting or other Purchase Agreement* *Item 2.03 – Creation of a Direct Financial Obligation of a Registrant*	Four business days after entry into the Indenture, Underwriting or Purchase Agreement

618 Note that if the offer proceeds are used to repay and terminate an existing credit agreement or indenture, disclosure must also be made under Item 1.02 – Termination of a Material Definitive Agreement.

619 *Id*.

620 *Id*.

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Event	Form 8-K Disclosure Item	Filing Deadline
	If the offering is not material, companies sometimes make a voluntary report under Item 8.01.	
Private offering of convertible debt securities	*Item 1.01*[621] *– Entry into a Material Definitive Agreement, as to any Indenture, Underwriting or other Purchase Agreement* *Item 2.03 – Creation of a Direct Financial Obligation of a Registrant* *Possibly Item 3.02 – Unregistered Sales of Equity Securities, if the debt securities are convertible into specified percentages of the company's outstanding equity securities* *If the offering is not material, companies sometimes make a voluntary report under Item 8.01 – Other Events.*	Four business days after entry into the Indenture, Underwriting or Purchase Agreement
Public or private offering of debt securities	*Item 1.01*[622] *– Entry into a Material Definitive Agreement, as to any Indenture, Underwriting or other Purchase Agreement*	Four business days after entry into the Indenture, Underwriting or Purchase

[621] *Id.*

[622] *Id.*

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Event	**Form 8-K Disclosure Item**	**Filing Deadline**
	Item 2.03 – Creation of a Direct Financial Obligation of a Registrant *If the offering is not material, companies sometimes make a voluntary report under Item 8.01 – Other Events.*	Agreement
Entry into a new Credit Agreement	*Item 1.01*[623] *– Entry into a Material Definitive Agreement* *Item 2.03 – Creation of a Direct Financial Obligation of a Registrant* *If the Credit Agreement is not material, companies sometimes make a voluntary report under Item 8.01 – Other Events.*	Four business days after entry into the Credit Agreement
Grant of a contractual waiver by lenders or debt security holders, if material	*Item 1.01 – Entry into a Material Definitive Agreement* *If the company wishes to disclose an oral waiver, it would do so under Item 8.01 – Other Events.*	Four business days after execution
Entry into a material capital or operating lease	*Item 1.01 – Entry into a Material Definitive Agreement* *Item 2.03 – Creation of a*	Four business days after execution

[623] *Id.*

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Event	Form 8-K Disclosure Item	Filing Deadline
	Direct Financial Obligation of a Registrant	
Creation of a material off-balance sheet obligation	*Item 2.03 – Creation of an Obligation under an Off-Balance Sheet Arrangement of a Registrant* *Possibly Item 1.01 – Entry into a Material Definitive Agreement, if the company is a party to the agreement creating the obligation.*	Four business days after incurring (either creating or becoming aware of) the obligation
Appointment of a bankruptcy receiver or entry of a bankruptcy order	*Item 1.03 – Bankruptcy or Receivership*	Four business days after the appointment or entry of order
Receipt of certain notices from the Mine Safety and Health Administration regarding imminent danger or pattern of violations	*Item 1.04 – Mine Safety – Reporting of Shutdowns and Patterns of Violations*	Four business days after receipt of the notice
Closing of an acquisition or disposition of a significant amount of assets outside of the ordinary course of business (greater than 10% of consolidated assets or involving a significant subsidiary or business as defined under Regulation S-X)	*Item 2.01 – Completion of Acquisition or Disposition of Assets* *Possibly Item 9.01 – Financial Statements and Exhibits, depending on the level of significance of the transaction*	Four business days after closing the asset acquisition or disposition
Earnings announcements or releases	*Item 2.02 – Results of Operations and Financial Condition*[624]	Four business days after the announcement

[624] Information reported under Item 2.02, and any related exhibits, are deemed to be "furnished" as opposed to "filed" with the SEC. Issuers are not subject to liability under Section 18 of the 1934 Act for information that is "furnished" to the SEC, but are still subject to general anti-fraud liability under Section 10(b) and Rule 10b-5. Issuers and underwriters are not subject to liability under the 1933 Act for information that is (continued)

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Event	Form 8-K Disclosure Item	Filing Deadline
		or release
Occurrence of an event which triggers an acceleration of, or increase in, a direct financial obligation or off-balance sheet arrangement that has material consequences for the company (such as an event of default that triggers automatic acceleration under a credit agreement or indenture)	*Item 2.04 – Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement*	Four business days after the occurrence of the event
Receipt of a notice of default under a credit agreement or indenture which does not yet trigger an acceleration of the debt	*Possibly Item 8.01 – Other Events, if the notice is deemed to be material.*	Four business days after receipt of the notice
Incurrence of material write-off or restructuring charges as a result of the company's adoption of an exit or disposal plan, disposition of long-lived assets, or termination of employees under a plan of termination	*Item 2.05 – Costs Associated with Exit or Disposal Activities* *Possibly Item 2.06 – Material Impairments, if impairment charges will be recorded*	Four business days after the incurrence of charges, disposition of assets or termination of employees
Incurrence of material impairment charge is required under US GAAP	*Item 2.06 – Material Impairments*	Four business days after the company determines it must incur this charge
Receipt of notice from the NYSE or NASDAQ of delisting or non-compliance with continued listing standards	*Item 3.01 – Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard*	Four business days after receipt of the notice
Notification to the NYSE or NASDAQ of non-compliance with continued listing standards	*Item 3.01 – Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard*	Four business days after the notification
Withdrawal or termination of listing from the NYSE or NASDAQ, including as a	*Item 3.01 – Notice of Delisting or Failure to*	Four business days after the

"furnished" to the SEC unless the issuer expressly incorporates that information by reference into the applicable registration statement.

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Event	Form 8-K Disclosure Item	Filing Deadline
result of a transfer of listing	*Satisfy a Continued Listing Rule or Standard; Transfer of Listing*	withdrawal or termination of listing
Material modification to the instruments defining the rights of holders of any publicly registered securities (such as charter documents defining the rights of equity security holders or indentures defining the rights of debt security holders)	*Item 3.03 – Material Modification to Rights of Security Holders*	Four business days after the rights are materially modified (such as by entering into an agreement)
Resignation or dismissal of the company's audit firm, including any supplemental audit firm that the principal audit firm relies on in issuing its report	*Item 4.01 – Changes in Registrant's Certifying Accountant*	Four business days after the resignation or dismissal
Engagement of a new audit firm, including any supplemental audit firm that the principal audit firm relies on in issuing its report	*Item 4.01 – Changes in Registrant's Certifying Accountant*	Four business days after the engagement
Determination that a restatement of financial statements for a prior period is required	*Item 4.02 – Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review*	Four business days after the company determines the restatement is required
Occurrence of a change in control with respect to the company	*Item 5.01 – Changes in Control of Registrant*	Four business days after the closing of the transaction
Director's resignation or refusal to stand for re-election due to a disagreement with the board, or dismissal for cause	*Item 5.02(a) – Departure of Directors or Certain Officers*	Four business days after the resignation or dismissal
Director's retirement, resignation or refusal to stand for re-election not due to a disagreement with the board, or dismissal not for cause	*Item 5.02(b) – Departure of Directors or Certain Officers, and question 117.01 of the Compliance and Disclosure Interpretations of Form 8-K*	Four business days after notice of a decision to retire, resign or refuse to stand for re-election provided by the director or four business

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Event	Form 8-K Disclosure Item	Filing Deadline
		days after dismissal
Resignation, retirement, or dismissal of an executive officer named in the company's most recent summary compensation table	*Item 5.02(b) – Departure of Directors or Certain Officers*	Four business days after the resignation, retirement or dismissal
Appointment of a new chief executive officer, president, chief financial officer, chief operating officer, controller, or persons performing similar functions	*Item 5.02(c) – Appointment of Certain Officers*	Four business days after the appointment
Appointment of a new director by the board to fill a vacancy (other than by stockholder vote at a meeting)	*Item 5.02(d) – Election of Directors*	Four business days after the appointment
Entry into, or material amendment of, an employment agreement with an executive officer named in the company's most recent summary compensation table	*Item 5.02(e) – Compensatory Arrangements of Certain Officers*	Four business days after execution
Entry into, or material amendment of, a stock option or cash incentive plan (that is not available on the same terms to all employees)	*Item 5.02(e) – Compensatory Arrangements of Certain Officers* *If approved by stockholders, Item 5.07 – Submission of Matters to a Vote of Security Holders*	Four business days after execution Note that if stockholder approval is also given, the deadline to file is triggered upon approval by stockholders, not upon adoption by the board
Issuance or material modification of a material equity or cash award, where the terms of such award have not been previously disclosed	*Item 5.02(e) – Compensatory Arrangements of Certain Officers*	Four business days after execution
Issuance of non-material awards under the board of director's authority to approve bonus payments when performance targets	*Item 5.02(e) – Compensatory Arrangements of Certain*	Four business days after execution

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Event	Form 8-K Disclosure Item	Filing Deadline
were not achieved	*Officers, and question 117.11 of the Compliance and Disclosure Interpretations of Form 8-K)*	
Amendment of the company's articles of incorporation or bylaws that was not previously disclosed in a proxy statement	*Item 5.03(a) – Amendments to Articles of Incorporation or Bylaws*	Four business days after the amendment
Change in fiscal year without submission to a stockholder vote or amendment to articles of incorporation or bylaws	*Item 5.03(b) – Change in Fiscal Year*	Four business days after the change or amendment
Commencement of a blackout period under one of the company's employee benefit plans	*Item 5.04 – Temporary Suspension of Trading Under Registrant's Employee Benefit Plans*	Four business days after receipt of notice from the plan administrator of the blackout period or, if no notice is given, the date the company notifies its affected directors and officers
Amendment to, or waiver of, a provision of the company's code of ethics that applies to the chief executive officer, president, chief financial officer, chief operating officer, controller, or persons performing similar functions	*Item 5.05 – Amendments to the Registrant's Code of Ethics, or Waiver of a Provision of the Code of Ethics*[625]	Four business days after the amendment or waiver
A shell company completes an acquisition	*Item 5.06 – Change in*	Four business

[625] Item 5.05 also permits disclosure to be made on the company's website as an alternative to filing a Form 8-K if the company has disclosed in its most recently filed annual report its website address and intent to provide disclosure in this way.

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Event	Form 8-K Disclosure Item	Filing Deadline
or otherwise ceases to be a shell company (unless the shell company was created solely for the purpose of completing a business combination)	*Shell Company Status* *Item 2.01 – Completion of Acquisition or Disposition of Assets* *Possibly Item 5.01 – Changes in Control of Registrant* *Possibly Item 1.01 – Entry into a Material Definitive Agreement, if the transaction involves any such agreements*	days after closing the transaction that results in the company ceasing to be a shell company
Results of a stockholder vote (other than a vote regarding the frequency of say on pay voting)	*Item 5.07 – Submission of Matters to a Vote of Security Holders*	Four business days after the stockholders' meeting ends
Results of a stockholder vote regarding the frequency of say on pay voting, which requires an amendment to the Form 8-K	*Item 5.07 – Submission of Matters to a Vote of Security Holders*	The earlier of 150 days after the stockholders' meeting or 60 days before the stockholder proposal submission deadline for the next stockholders' meeting
If the company did not hold an annual meeting in the past year or the date of the upcoming annual meeting changes by more than thirty calendar days, it must disclose the deadline for nominating stockholders to give notice on Schedule 14N	*Item 5.08 – Shareholder Director Nominations*	Four business days after the company determines the date of its annual meeting
Certain events relating to asset-backed securities issued by the company, including any:	*Items 6.01 to 6.05 – Asset-Backed Securities*	Four business days after the occurrence of

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Event	Form 8-K Disclosure Item	Filing Deadline
• change of servicer or trustee; • change in credit enhancement or other external support; • failure to make a required distribution; or • change in any material pool characteristic of the actual asset pool at issuance differs by 5% or more (other than as a result of the pool assets converting into cash in accordance with their terms) from the description of the asset pool in the prospectus filed for the offering pursuant to the 1933 Act		the specific event
Disclosure obligations under Regulation FD, such as a press release or transcript of an investor or analyst conference call (For a description of Regulation FD obligations, see Chapter 7 (*Ongoing Reporting and Other Requirements*)—Communications with Investors and the Public—Regulation FD)	*Item 7.01 – Regulation FD Disclosure*[626]	If intentional, simultaneously with the disclosure If unintentional, the later of the commencement of the next day's trading on the NYSE or 24 hours after the disclosure
Other material events, not specifically called for by other items of Form 8-K, that the company deems to be of importance to its security holders. This would typically include events such as: • Declaration of a dividend • Stock splits • Stock repurchase programs	*Item 8.01 – Other Events*	No filing deadline

[626] Information reported under Item 7.01, and any related exhibits, are deemed to be "furnished" as opposed to "filed" with the SEC. See footnote 7 for more information.

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Event	Form 8-K Disclosure Item	Filing Deadline
• Spin-offs of subsidiaries • Redemption or repayment of debt • Filing or settlement of material litigation • Grant or denial of material regulatory approvals		
Financial statements or exhibits that are required to be filed or furnished by one of the previous Form 8-K items	*Item 9.01 – Financial Statements and Exhibits*	As required by the relevant Form 8-K item

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