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STRUCTURING A CROSS-BORDER SECURITIES OFFERING: COMMON U.S. EXEMPTIONS FROM REGISTRATION

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Due to the size and scope of the U.S. capital markets, U.S. investors can form a meaningful add-on tranche to both public and private Canadian securities offerings. However, the legal mechanics of structuring a cross-border offering may seem daunting to Canadian issuers and their advisors. A Canadian issuer seeking access to the U.S. capital markets faces a largely binary choice between:

1. Conducting an SEC-registered offering and immediately becoming subject to ongoing and costly reporting requirements under the U.S. Securities Exchange Act of 1934, or
2. Using a targeted financing under an established legal exemption from registration.

If option two is the desired outcome, this article provides a road map to structure the U.S. tranche under one of the below commonly used exemptions to SEC registration. Please note that this outline is for discussion purposes only. Any time U.S. investors are being considered in a cross-border offering, U.S. counsel should be engaged early in the process. The consequences to an issuer that loses an exemption post-hoc are severe—penalties can involve rescission plus interest. The parameters of the offering on both sides of the border should thus be established well in advance.

The Canadian Offering / Regulation S

U.S. securities regulations do not apply to offshore transactions with no nexus to the United States (for example, a transaction that is executed on a foreign securities exchange located outside the United States—e.g., TSX, TSX–V—to a non-U.S. buyer). Where U.S. investors are part of the offering, however, it is often helpful to conceptualize a cross-border securities offering as comprising two separate offerings proceeding on parallel tracks on either side of the border. Properly structured, the tranche of securities being placed in Canada (whether on a public or private basis pursuant to Canadian law) is known in U.S. parlance as the “Regulation S Offering.”

Regulation S of the U.S. Securities Act of 1933, as amended (the Securities Act) provides a safe harbor from U.S. registration for offers and sales of securities that are clearly outside the United States. While there are several components to the analysis, in general:

1. The offer or sale must be made in an offshore transaction; and
2. There must be no directed selling efforts in the United States.

The term "directed selling efforts" has a broad definition to include any activities that can reasonably be expected to have the effect of conditioning the U.S. market for the Regulation S Offering. Although generally the purview of Canadian counsel, the documentation relating to the Canadian tranche should be reviewed by U.S. counsel to ensure compliance with this requirement and other applicable U.S. securities laws. In particular, the issuer must be careful that any publicity (press releases, etc.) used in connection with the Canadian offering be restricted from dissemination in the U.S. as they would likely constitute "directed selling efforts" – the release of which could render the exemption inapplicable. Practically speaking, this usually means the inclusion of prominent legends atop Canadian publicity and press releases that make clear they are not intended for U.S. distribution.

If the conditions of Regulation S are met, the Canadian portion of the offering is deemed to take place outside the United States and such transaction will not be integrated with a concurrent U.S. offering—hence, the two concurrent offerings conceptualization. Depending on the circumstances, securities sold in the Regulation S Offering may also bear restrictive legends to limit their flow into the United States.

Categories of Exempt U.S. Offerings

Having determined that the Canadian offering is exempt from U.S. registration, we now turn our attention to the recognized exemptions that are most commonly used to structure the U.S. portion of the offering.

The General Private Placement Exemption

Section 4(a)(2) of the Securities Act provides an exemption for "transactions by an issuer not involving any 'public offering.'" The term "public offering" is not defined in the Securities Act, and the scope of the Section 4(a)(2) exemption has largely evolved through case law, SEC pronouncements, and market practice. The core issue is whether the persons to whom securities are offered need the protections of the Securities Act, or whether they are sufficiently sophisticated as to be able to fend for themselves.

The private placement exemption based on Section 4(a)(2) of the Securities Act generally applies to offers and sales by an issuer that meets the following:

- A non-public offering without general solicitation or advertising to a limited number of offerees;
- Who are buying for investment and not with a view to distribution; and
- Who are sophisticated investors and have been provided with or have access to information about the issuer.

Offerees buying securities issued in a private placement will generally make these representations in the subscription agreement. Securities sold in a private placement are "restricted securities" for the purposes of U.S. securities laws and will include restrictions on resale in the form of stop-transfer orders and/or restrictive legends. Further resales of such securities will require a separate exemption, such as Rule 144A discussed below.

Rule 144A

Rule 144A of the Securities Act provides an exemption for the resale of privately-placed restricted securities only to certain Qualified Institutional Buyers (QIBs), that are deemed to be sophisticated investors. QIBs include U.S.-regulated insurance companies, investment companies, certain employee benefit plans, trusts, broker-dealers, and banks that in the aggregate own and invest on a discretionary basis at least US$100 million in securities of issuers that are not affiliated with the QIB.

Because of the two-step nature of this exemption (private placement by the issuer followed by resale to QIBs), Rule 144A is most often used in connection with fully underwritten offeringsby an issuer to an initial syndicate of investment banks or "initial purchasers," who in turn sell these securities to QIB investors. Conversely, Rule 144A is not typically used in agency deals where a placement agent is engaged by the issuer to help place the securities directly with the investors. Rule 144A also cannot be used if the securities to be sold are of the same class as securities of the issuer that are traded on a U.S. securities exchange.

Regulation D (Rule 506) Safe Harbor

As you can see above, it is not possible to map the borders of Section 4(a)(2) with absolute precision. As is common throughout the Securities Act, a "safe harbor" is provided by Rule 506 of Regulation D, now split into two distinct components.

Under Rule 506(b), an exemption from registration is deemed to be recognized if the issuer meets the following conditions:

- Sale of securities to an unlimited number of sophisticated investors that fall into recognized categories of "accredited investors" (AIs) under Regulation D (refer to Annex I hereto). Issuers and placement agents typically satisfy this requirement by having potential investors complete investor questionnaires attached to the subscription agreement, demonstrating their accredited status and their sophistication. Up to 35 non-accredited investors may also participate in the offering; however, such investors are entitled to extensive information about the issuer substantially in line with SEC registration requirements, so many Rule 506(b) offerings proceed only with AIs.

- The securities sold in a Regulation D offering are restricted securities that cannot be freely resold absent registration or an exemption therefrom. Additionally, the issuer must take "reasonable care" to make sure that purchasers are not deemed to be engaged in onward distribution of the securities. This is typically satisfied by reasonable inquiry as to investor status and intent, written disclosure as to restricted status, and the inclusion of restrictive legends on the security itself.

- The issuer must file a Form D with the SEC within 15 days after the first sale of securities—essentially, a notice filing that discloses basic details of the offering,

- No general solicitation or advertising is used in connection with the offering.
- "Bad actor" disqualification: under recently adopted rules, an issuer will not be able to rely on the Rule 506 exemption if it or certain other "covered persons" have been subject to certain disqualifying events linked to securities fraud. An issuer can protect itself if it takes "reasonable care" to discover the existence of these events. Many issuers are now taking proactive steps to include such questions in standard D&O questionnaires as part of ongoing compliance.

Under Rule 506(c), general solicitation and advertising in the United States are permitted in connection with the Regulation D offering if *all* purchasers of the offered securities are AIs and the issuer takes "reasonable steps to verify" that the purchasers are AIs. Under Rule 506(c), a simple representation by the investor as to its status is not sufficient. Whether the investor verification steps taken by an issuer are reasonable depends on the facts and circumstances, although the SEC has issued some guidance on suggested verification methods, especially as they pertain to the AI income and net-worth tests (which may include review of tax returns, bank statements, and other documentation). Rule 506(c) offerings are otherwise subject to the requirements of Regulation D outlined above, including Form D filings, bad actor disqualification, and restrictions on transfer.

Frequently Asked Questions

Q: What is the difference between AIs and QIBs?

A: The term "accredited investor" encompasses several categories of investors deemed by statute to possess the requisite resources and sophistication to enter into a Regulation D offering. These categories include both institutions and certain high-income/high-net-worth individuals. QIBs represent a subset of very large institutional AIs having investment discretion of over US$100 million. In short, all QIBs are AIs, whereas only some AIs are QIBs. By virtue of being AIs, QIBs can participate in a Regulation D offering; however, they are accorded no special treatment as a virtue of this QIB status (QIB is not a recognized category for purposes of Regulation D) and are treated like the other AIs investing in the Regulation D offering. Because only QIBs can participate in a Rule 144A transaction, however, many categories of AIs (including all the individual AI categories) will be precluded from purchasing Rule 144A securities.

Q: In a cross-border offering structured to be public in Canada but pursuant to one of the U.S. exemptions discussed above, how does a U.S. buyer resell its securities?

A: As discussed above, securities sold under one of the above exemptions are "restricted securities" for purposes of U.S. securities law and are typically issued with legends restricting them from transfer unless i) the securities become registered in the United States, or, ii) pursuant to a recognized resale exemption, often requiring an opinion of U.S. counsel. Perhaps the exemption most applicable to the cross-border context (and likely the exemption that will provide the most liquidity to the U.S. investor) is contained in the resale provisions of Regulation S – sales outside the United States. Per the discussion above, offshore transactions directed to non-U.S. buyers are exempt from U.S. registration. Yet the Canadian buyer will also want to take an unlegended security fungible with the securities being traded on a Canadian exchange. Rule 905 of Regulation S provides that equity securities of U.S. issuers continue to be restricted and the legend would not "wash off" even after a transfer pursuant to Regulation S. However, in its adopting release of this rule, the SEC clarified that Rule 905

did not apply to securities of foreign issuers. Once resold to a Canadian buyer, the seller in this case can apply to the issuer's transfer agent to remove the U.S. restrictive legends from the security.

Q: Should restrictive legends be included on all securities sold under Rule 144A and Regulation D?

A: The short answer is yes, as Rule 144A and Regulation D securities are "restricted securities".

An emerging practice has developed in certain Canadian IPOs (i) structured as Rule 144A offerings in the U.S. and (ii) where there is little to no U.S. market for the securities whereby the QIB buyer signs the subscription agreement agreeing to abide by the restrictions contained therein and in the restrictive legend, but takes unlegended shares in practice. Essentially the legend is implied and the QIB contractually agrees to comply with the restrictions contained therein, however the QIB will not have to undertake the time-consuming process of de-lengending its shares if it wished to trade them subsequently in Canada.

Q: Now that the SEC has permitted general solicitation to be used in connection with a Rule 144A offering and certain Regulation D offerings pursuant to new Rule 506(c), are issuers now permitted to disseminate the Canadian marketing materials across the border into the U.S.?

A: In the absence of definitive guidance on this point from the SEC, we would advise issuers not to do this. In its release adopting new Rule 506(c), the SEC reiterated its position that concurrent offerings under Regulation D and Regulation S will not be integrated. Thus, activities that involve general solicitation or general advertising under new Rule 506(c) will not preclude the issuer from relying on Regulation S for its non-U.S. offering. However, the SEC did not grant a request by multiple commenters to confirm that the use of general solicitation under new Rule 506(c) would not be deemed to constitute "directed selling efforts" by the same issuer in connection with a contemporaneous offering under Regulation S. Practically speaking, if the issuer decides to use general solicitation in connection with a Rule 144A or Rule 506(c) offering, it should maintain disclaimers indicating its intent that the specified communications are being made exclusively to residents of one side of the border or the other and segregate the information accordingly.

Additional Considerations

In addition to the exemptions from federal registration discussed herein, issuers must also abide by state securities laws, known colloquially as "blue sky laws." A discussion of these is beyond the scope of this article and will be discussed in a future publication. Additionally, issuers selling securities in the United States. must always bear in mind the general anti-fraud provisions of both federal and state securities laws.

Please contact Timothy Ho for more information.

Annex I – Categories of Accredited Investors

For purposes of Regulation D, an investor must fit within one or more of the categories below to meet the "accredited investor" definition:

- A bank as defined in Section 3(a)(2) of the U.S. Securities Act, whether acting in its individual or fiduciary capacity;
- A savings and loan association or other institution as defined in Section 3(a)(5)(A) of the U.S. Securities Act, whether acting in its individual or fiduciary capacity;
- A broker or dealer registered pursuant to Section 15 of the U.S. Securities Exchange Act of 1934;
- An insurance company as defined in Section 2(a)(13) of the U.S. Securities Act;
- An investment company registered under the U.S. Investment Company Act of 1940;
- A business development company as defined in Section 2(a)(48) of the U.S. Investment Company Act of 1940;
- A Small Business Investment Company licensed by the U.S. Small Business Administration under Section 301(c) or (d) of the U.S. Small Business Investment Act of 1958;
- A plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of US$5,000,000;
- An employee benefit plan within the meaning of the U.S. Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in Section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of US$5,000,000, or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;
- A private business development company as defined in Section 202(a)(22) of the U.S. Investment Advisers Act of 1940;
- An organization described in Section 501(c)(3) of the Internal Revenue Code, a corporation, a Massachusetts or similar business trust, or a partnership, not formed for the specific purpose of acquiring the securities, with total assets in excess of US$5,000,000;
- A director or executive officer of the issuer;
- A natural person whose individual net worth, or joint net worth with that person's spouse, at the time of the person's purchase exceeds US$1,000,000 (for purposes of calculating net worth: (i) the person's primary residence shall not be included as an asset; (ii) indebtedness that is secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability (except that if the amount of such indebtedness outstanding at the time of the sale of securities exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess shall be included as a liability); and (iii) indebtedness that is secured by the person's primary residence in excess of the estimated

fair market value of the primary residence shall be included as a liability);

- A natural person who had an individual income in excess of US$200,000 in each of the two most recent years or joint income with that person's spouse in excess of US$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;
- A trust, with total assets in excess of US$5,000,000, not formed for the specific purpose of acquiring the securities, whose purchase is directed by a sophisticated person, being defined as a person who has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment;
- An entity in which all of the equity owners meet one or more of the categories set forth above.