FOREIGNERS GET SPECIAL TREATMENT: SEC UPDATES GUIDANCE TO FOREIGN PRIVATE ISSUERS

Smarter Way to Cross Blog Archives
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The CFO of a Canadian dual-listed company calls you in a panic because it has recently come to his attention that, to his great surprise, the majority of his shareholders are not in fact Canadian, but American! He recalls hearing snippets of advice from a US securities lawyer that this could be problematic for his "FPI" status. Could it mean he is now treated as a domestic company under U.S. Securities Laws? Before you dash off a frantic email to your U.S. attorney, let's quickly review what the panic is all about. What is FPI status, how is it determined and why is it important?

One of the key distinctions in the U.S. securities laws is drawn between domestic U.S. and non-U.S. companies, and in particular, a category of non-U.S. companies known as "foreign private issuers" (or "FPI"s). The reference to "private" in the FPI name can be misleading—the distinction it draws is between a private entity as opposed to a foreign government; it has nothing to do with whether the issuer is publicly or privately traded. Importantly, a Canadian company that is publicly traded (in or outside the United States) can still be an FPI and qualify for the benefit of various exemptions under U.S. Securities Laws. In this blog post, I will discuss how to ensure you qualify for FPI treatment, touching on some recent pronouncements by the SEC. I will then outline the FPI benefits that are of greatest concern to a typical Canadian issuer.

What is a Foreign Private Issuer?

An FPI is an entity (other than a foreign government) incorporated or organized under the laws of a jurisdiction outside of the U.S. unless:

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

Crucially for the CFO mentioned above and many other Canadian companies, an issuer organized under Canadian law that has more than 50% U.S. ownership can still be an FPI, so long as none of the conditions outlined in the second prong above is satisfied.

What if the Company has multiple classes of outstanding voting securities?

Earlier this month, the SEC released a set of Compliance and Disclosure Interpretations (or "CD&I") relating to FPI's, including one to clarify that companies with more than one class of voting securities with different voting rights may assess the 50% threshold either by (i) determining whether U.S. residents own more than 50% of the voting power of the classes on a combined basis or (ii) by determining whether U.S. residents own more than 50% of the number of outstanding voting securities.

How is U.S. ownership of record determined?

A Canadian company would start by reviewing the addresses of its registered stockholders. However, it first needs to look past institutional custodians (such as DTC) and other commercial depositories to identify participants in those systems. It must then drill down beyond "street name" accounts (i.e., accounts held of record by a broker-dealer, bank or nominee) and determine the number of accounts located in (i) the U.S., (ii) in Canada and (iii) the jurisdiction that is the primary trading market for the company's voting securities (if not in Canada). In each scenario, the number of separate accounts in which the shares are held should be counted. Importantly, the SEC clarified in a recent CD&I that a person with a green card is assumed to be a U.S. resident, but other persons without such permanent residency may also be deemed U.S. residents. When conducting shareholder counts for this purpose, Canadian shareholders must ensure it is applying a consistent set of criteria (not changing them to achieve a desired result), which may include physical presence, mailing address, nationality or tax residence.

Per SEC guidance, a company may rely in good faith on information as to the number of these separate accounts supplied by a broker, bank or nominee. If, after reasonable inquiry, the company is unable to obtain information about the amount of securities represented by accounts of customers resident in the United States, it may assume that these customers are residents of the jurisdiction in which the nominee has its principal place of business. For example, the Company believes that there are 30 shareholders being represented by accounts held by a nominee called "ABC Bank Canada". ABC Bank Canada, for privacy reasons, is refusing to divulge any further information on the identity of these shareholders, including their country of residence. If the Company has made a reasonable inquiry, it may assume that the 30 shareholders are all Canadian residents if ABC Bank Canada has a Canadian principal address.

What factors are involved in the determination of board / officer residency?

This assessment involves the following four determinations: the citizenship of executive officers, the residency of executive officers, the citizenship of directors and the residency of directors.

What factors are involved in determining location of assets and administration of the business?

The SEC clarified in a recent CD&I that in making this determination, a company may rely on the geographic segment information from its financial statements, or may rely on another reasonable methodology that is consistently applied. Another CD&I released at the same time indicated that the determination of the geographic administration of the business (inside or outside the U.S.) is an exercise of judgment by the issuer, as no single factor or group of factors are determinative. For example, holding a shareholders meeting or occasional board of directors meetings in the U.S. does not necessarily mean that the business is administered principally in the U.S. Rather, the company should assess on a consolidated basis the location from which its officers, partners, or managers primarily direct, control and coordinate the company's activities.

In summary, although the FPI definition seems clearly laid out in the statute, the actual determination of whether a company fits under each prong is often based on judgment calls that must be rational and consistently applied.

Why is FPI Status so important?

FPIs enjoy several exemptions from SEC rules applicable to domestic U.S. publicly-reporting companies. Among these are:

- The financial statements of Canadian FPIs that report to the SEC can be made using IFRS without a reconciliation to U.S. GAAP.
- Canadian FPIs can take advantage of the SEC's Multijurisdictional Disclosure System (MJDS), which is a condensed reporting regime allowing certain Canadian issuers to satisfy its U.S. reporting requirements by substantial reliance on its home country reports.
- FPIs are not required to file quarterly reports on Form 10-Q. They are also not required to use Form 8-K for current reports, and instead furnish current reports on Form 6-K with the SEC. That being said, some FPIs choose (or are required by contact) to make quarterly filings or furnish quarterly information on Form 6-K.
- FPIs have more time to file annual reports on Form 20-F with the SEC – 4 months after the end of their fiscal year.
- FPIs are exempt from Section 16 reporting, which is the statutory scheme for domestic U.S. issuers to disclose the stock ownership (and changes thereto) of executive officers, directors and 10% holders.
- FPIs are not subject to U.S. proxy rules and thus a Canadian issuer can communicate with shareholders (including U.S. shareholders) using Canadian proxy rules.
- S. shareholders holding securities that were privately placed into the United States (such securities are legended and restricted under U.S. law) by an FPI that is traded on a Canadian stock exchange can take advantage of Rule 904 under the U.S. Securities Act to resell these securities on such Canadian stock exchange on an unrestricted basis and apply to have the restrictive legends removed, if certain conditions are met.