Public and private entities can access the U.S. capital markets without registering the offering with the U.S. Securities and Exchange Commission (SEC) by issuing securities under Rule 144A and/or Regulation S of the U.S. Securities Act of 1933, as amended (the Securities Act). Rule 144A offerings are typically used to offer non-convertible or convertible debt and preferred stock. Rule 144A and Regulation S offerings are frequently conducted simultaneously and give an issuer the flexibility to offer its securities inside the United States in reliance on Rule 144A at the same time as it offers its securities outside the United States in reliance on Regulation S. These offerings are particularly attractive to issuers of debt in low-interest-rate environments. Private entities, including foreign issuers, view Rule 144A and Regulation S offerings favorably because such offerings provide an opportunity to raise capital without subjecting themselves to the burdensome periodic filing requirements of the SEC or the internal controls requirements imposed by the Sarbanes-Oxley Act of 2002 (SOX). Because of the absence of SEC registration and review, Rule 144A and Regulation S offerings are also typically accomplished at a lower cost than a registered U.S. underwritten offering.

The process for Rule 144A and Regulation S offerings is similar to underwritten U.S. registered offerings. The issuer would prepare an offering memorandum with the assistance of its legal counsel and the initial purchasers (the analog to the underwriters in a registered offering) and their legal counsel. An offering memorandum would be similar to an initial public offering prospectus and would include operational and financial information about the issuer, risk factors, use of proceeds, capitalization, management’s discussion and analysis of the issuer’s financial condition and results of operations, plan of distribution and other customary disclosures. The operative documents that will require negotiation include an indenture (for debt offerings), a purchase or placement agreement and customary pricing and closing deliverables such as officers’ certificates. An offering memorandum for a debt offering would also include a section with a description of the notes being issued, which includes the material terms of the notes. The issuer’s independent auditor would be required to deliver a comfort letter addressed to the initial purchasers with respect to the financial information included in the offering memorandum. Legal counsel for the issuer and the initial purchasers would also be required to deliver legal opinions and a 10b-5 negative assurance relating to the offering documents.

In addition, an issuer would be subject to certain standard incurrence-based covenants relating to indebtedness, affiliated party transactions, restricted payments, restricted transactions, liens and periodic financial reports, among others. There could also be additional covenants relating to certain ratios and maintenance obligations depending on the issuer’s business and financial position and the structure of the notes. These additional covenants are considered on a case-by-case basis and are subject to negotiation.

Once the offering memorandum is complete and the operative documents have been agreed to in principle, the issuer’s management and the deal team from the initial purchasers will go on a “road show.” The securities will be priced at the conclusion of the road show and the parties will sign the purchase or placement agreement and other signing deliverables. The ultimate terms of the securities will depend on the success of the road show and the market and interest
rate environment (with respect to debt offerings) at the time of pricing. The maturity of notes issued in connection with a Rule 144A or Regulation S debt offering customarily range from seven to 10 years.

The issuer's management should begin the process of obtaining ratings of its notes weeks in advance of any debt issuance. The rating process includes due diligence by the rating agencies, management presentations and meetings. It is also important to obtain eligibility from The Depository Trust & Clearing Corporation (DTC) prior to closing a Rule 144A or Regulation S offering if the securities will be listed for trading on a foreign stock exchange. In addition, the listing application must be approved by the applicable foreign stock exchange in advance. The foreign stock exchange approval process includes a review of the offering memorandum and compliance with the foreign stock exchange's disclosure rules, which must be summarized in the offering memorandum. It is advisable that issuer's legal counsel coordinate with the foreign stock exchange examiner as soon as possible in the process.

**Rule 144A Background**

Rule 144A is a non-exclusive safe harbor from the registration requirements of Section 5 of the Securities Act for certain private reoffers and resales of securities to qualified institutional buyers (QIBs). QIBs include institutions that in the aggregate own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the institution. An individual can never be deemed a QIB. In addition, there is a net worth requirement of $25 million for banks, savings and loan associations. A registered broker-dealer participating in a Rule 144A transaction can also be deemed a QIB so long as the broker-dealer in the aggregate owns and invests on a discretionary basis at least $10 million of securities of issuers that are not affiliated with the broker-dealer or in connection with a riskless principal transaction. A riskless principal transaction is when a QIB commits to purchase the securities from the broker-dealer simultaneously at the closing.

Securities of U.S. and foreign issuers are eligible for resale under Rule 144A so long as such securities are not listed on a U.S. national securities exchange or quoted in a U.S. automated inter-dealer quotation system. This rules out the offering of listed common stock under Rule 144A. As a technical matter, the Rule 144A safe harbor is only available to sellers of securities other than the issuer. As a result, an issuer must rely on another exemption from the registration requirements of Section 5 of the Securities Act, which is typically Section 4(a)(2), Regulation D or Regulation S of the Securities Act, when selling the securities to one or more initial purchasers. The initial purchasers then immediately resell the securities to a number of QIBs.

Issuers in Rule 144A offerings also have certain ongoing disclosure obligations to the security holders and their prospective purchasers. If the issuer is not (i) a reporting company subject to Section 13 or 15(d) of the Exchange Act, (ii) exempt from reporting pursuant to Rule 12g3-2(b) under the Exchange Act, or (iii) a foreign government (as defined in Rule 405 of the Securities Act), the holder and a prospective purchaser designated by the holder have the right to obtain from the issuer the following information (which must be “reasonably current” in relation to the date of resale): (a) a brief statement of the nature of the business of the issuer and the products and services it offers, and (b) the issuer’s most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for two preceding fiscal years (which should be audited to the extent reasonably available). The term “reasonably current” means that (i) the most recent balance sheet date must be as of a date less than 16 months before the date of resale, (ii) the most recent profit and loss and retained earnings statements must be for the 12 months preceding the date of the balance sheet, and (iii) the statement of the nature of the business of the issuer and the products and services it offers must be as of a date within 12 months before the date of resale. With respect to foreign issuers, however, the information required would be deemed “reasonably current” if such information meets the timing requirements of the foreign issuer’s home country or principal trading markets.

**Regulation S Background**

Regulation S is a non-exclusive safe harbor from the registration requirements of Section 5 of the Securities Act for offers and sales made outside the United States and resales outside the United States. The main conditions of the safe harbor are that: (i) the offer or sale are made in an “offshore transaction”
(outside the United States), and (ii) there be no “directed selling efforts” in the United States.6

In addition, Regulation S offerings by issuers and their affiliates are subject to additional conditions depending upon the risk of flow back into the United States. The additional conditions vary and are grouped by categories, referred to as “Category 1,” “Category 2” and “Category 3.”

There are no additional restrictions for Category 1 transactions since there is little risk of flow back into the United States. In order for securities to be eligible for Category 1, the securities must be:

(i) issued by a foreign issuer under circumstances where there is no substantial U.S. market interest in the securities

(ii) an overseas directed offering of any securities by a foreign issuer or of non-convertible debt securities by a U.S. issuer7

(iii) backed by the full faith and credit of a foreign government,8 or

(iv) offered to non-U.S. persons under a compensatory employee benefit plan established and administered pursuant to foreign law.9

Securities may be eligible for Category 2 if they are not eligible for Category 1 and are equity securities of a foreign issuer, or debt securities of a SEC-reporting issuer or of a non-reporting foreign issuer. Category 2 transactions are subject to:

(i) “offering restrictions” (described more fully below)

(ii) a 40-day distribution compliance period whereby such securities cannot be offered or sold to a U.S. person or for the account or benefit of a U.S. person (other than a distributor) for at least 40 days after the later of the date such securities were first offered or the closing date, and

(iii) for securities sold before the expiration of the 40-day distribution compliance period, each distributor must send a confirmation or other notice to the purchaser stating that the purchaser is subject to the same restrictions on offers and sales that apply to a distributor.

Category 3 would be applicable to securities that are not eligible for Category 1 or Category 2, including, among other types of securities, debt securities of a non-reporting U.S. issuer or common stock of a reporting or non-reporting U.S. issuer.

Category 3 transactions are subject to:

(i) “offering restrictions”

(ii) for debt securities,

(a) a 40-day distribution compliance period, and

(b) the global note must not be exchangeable for definitive securities until after a 40-day distribution compliance period, and for any person other than a distributor, until receipt of a certification of beneficial ownership from a non-U.S. person or a U.S. person who purchased securities in a transaction that did not require registration under the Securities Act

(iii) for equity securities,

(a) a one-year distribution compliance period (or 6 months if the issuer is a reporting issuer), and

(b) if an offer or sale is made before the expiration of the one-year distribution compliance period,

(1) the purchaser (other than a distributor) must certify that it is not a U.S. person and is not acquiring the securities for the account or benefit of any U.S. person or is a U.S. person who purchased securities in a transaction that did not require registration under the Securities Act

(2) the purchaser agrees to resell the securities only in compliance with Regulation S, pursuant to registration under the Securities Act, or pursuant to an applicable exemption from such registration requirements, and the purchaser agrees not to engage in hedging transactions with respect to such securities unless in compliance with the Securities Act

(3) the securities of a U.S. issuer must contain a legend describing the restrictions to resell the securities only in compliance with Regulation S, pursuant to registration under the Securities Act, or pursuant to an applicable exemption from such registration requirements, and that the purchaser agrees not to engage in hedging transactions with respect to such securities unless in compliance with the Securities Act, and
(4) the issuer is contractually required to refuse to register any transfer of the securities not made in accordance with Regulation S, pursuant to registration under the Securities Act, or pursuant to an exemption from such registration requirements, and

(iv) for securities sold before the expiration of the 40-day, six-month or one-year distribution compliance period, as applicable, each distributor must send a confirmation or other notice to the purchaser stating that the purchaser is subject to the same restrictions on offers and sales that apply to a distributor.11

The “offering restrictions” applicable to Category 2 and Category 3 transactions provide that each distributor must agree in writing to (i) abide by the applicable distribution compliance period or the registration requirements or exemption therefrom under the Securities Act, and (ii) for offers and sales of equity securities of U.S. issuers, not to engage in hedging transactions with respect to such securities unless in compliance with the Securities Act. All offering materials and documents must also include an appropriate legend setting forth the applicable offer and sale restrictions imposed by Regulation S.

It is important to note that any offering pursuant to Regulation S must also be compliant with the laws and requirements of any applicable foreign jurisdiction and the rules and regulations of any applicable foreign securities exchange or listing authority. As a result, an issuer offering securities under Regulation S will need the assistance of both U.S. and local counsel.

ENDNOTES

1 Issuers should note that any issuer with more than $10 million in assets and 2,000 or more holders of record, or 500 or more holders of record who are not “accredited investors” (subject to certain exceptions) would be required to register the applicable class of securities under Section 12(g) of the U.S. Securities and Exchange Act of 1934, as amended (the Exchange Act). For bank holding companies, the threshold number of shareholders is 2,000 or more holders of record (subject to certain exceptions).

2 A placement agreement could be appropriate for Regulation S securities offerings whereby the investment banks do not purchase securities for resale but rather serve as “placement agents” that assist the issuer with finding interested buyers. Investment banks take on very little transaction risk in a private placement. In contrast, an issuer would bear the risk of a failed private placement transaction.

3 It should be noted that Title II (Access to Capital for Job Creators) of the Jumpstart Our Business Startups Act (the JOBS Act) directed the SEC to revise Rule 144A to permit securities to be offered to persons other than QIBs, including through general solicitation or advertising, provided that such securities wind up being sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a QIB. Title II of the JOBS Act is still awaiting rulemaking by the SEC although the SEC has issued a proposed rule to eliminate the prohibition against general solicitation and general advertising in Rule 506 and Rule 144A offerings. The proposed rule can be found at: http://www.sec.gov/rules/proposed/2012/33-9354.pdf. For additional information relating to the JOBS Act, see our prior Client Alert, “If Three’s a Crowd, Thousands Are ... an Investment Round? JOBS Act Presents Significant Changes to the Federal Securities Laws,” published March 29, 2012.

4 Open-end investment companies or unit investment trusts registered or required to be registered or closed-end investment companies required to be registered, but are not registered, under the Investment Company Act of 1940 may not rely upon Regulation S.

5 See Rule 902(h) of Regulation S.

6 See id. at Rule 902(c).

7 See id. at Rule 903(b)(1)(ii).

8 See id. at Rule 903(b)(1)(iii).

9 See id. at Rule 903(b)(1)(iv).

10 If, however, foreign law prevents the issuer of the securities from refusing to register such transfers, other reasonable procedures must be implemented to prevent any transfer of securities not made in compliance with Regulation S.

11 There are additional conditions for guaranteed securities and warrants set forth in Rule 903(b)(4) and (5) of Regulation S.