Rule 144A Offerings

Here's the deal:

- Rule 144A is an exemption from the registration requirements of Section 5 of the Securities Act of 1933 (the "Securities Act") for offers and sales of qualifying securities by persons other than the issuer of the securities.
- As a condition of the Rule 144A exemption, the resale must be made only to a qualified institutional buyer ("QIB") or to a purchaser that the reseller (and any person acting on its behalf) reasonably believes to be a QIB, and the reseller must take reasonable steps to ensure that the purchaser is aware that the reseller is relying on Rule 144A in connection with the resale.
- Not all securities are eligible for resale pursuant to Rule 144A. Securities offered in reliance on Rule 144A must not be "fungible" with, or substantially identical to, a class of securities listed on a national securities exchange or quoted on an automated inter-dealer quotation system. Issuers must also be willing to provide or make available certain reasonably current information about the issuer to any purchasers.
- Rule 144A transactions may include (1) offerings of debt, convertible debt or preferred securities by public companies; (2) offerings by foreign issuers that do not want to become subject to U.S. reporting requirements; and (3) offerings of common stock by non-reporting issuers (i.e., "backdoor IPOs").
- Rule 144A is an attractive option for continuous offering programs, particularly those that offer complex securities and are not aimed at retail investors.

What's the Deal?

Every security offered or sold in the United States must either be registered with the U.S. Securities and Exchange Commission (the "SEC") under Section 5 of the Securities Act or must qualify for an exemption from such registration requirements. The Rule 144A exemption applies to resales to QIBs of qualifying securities by certain persons other than the issuer of the securities. Resellers that rely on the exemption are not "underwriters" within the meaning of Section 2(a)(11) of the Securities Act, as Rule 144A provides that reoffers and resales made in compliance with the rule are not "distributions." Resellers that are not issuers, underwriters, or dealers may rely on the exemption provided by Section 4(a)(1) of the Securities Act while resellers that are dealers may rely on Section 4(a)(3) of the Securities Act.

Under Rule 144(a)(3) of the Securities Act, securities acquired in a Rule 144A transaction are "restricted securities." Unless the securities are subsequently registered (for example, if a registration statement was filed pursuant to a registration rights agreement for the applicable securities), the securities will remain restricted for the duration of the applicable holding period. Resales of restricted securities may only be

made in reliance on an applicable exemption under the Securities Act. In addition to Rule 144, exempt resales of restricted securities also may be made in compliance with Rule 144A, the Section 4(a)(1½) exemption, Section 4(a)(7), or Regulation S.

At the state level, Section 18 of the Securities Act exempts Rule 144A transactions from state regulation if (i) the issuer of the securities being resold in the Rule 144A transaction has a class of securities listed and traded on the New York Stock Exchange, NYSE Amex or the Nasdaq Market System, and (ii) the securities being resold in the Rule 144A transaction are equal or senior to the issuer's listed securities. For Rule 144A offerings of issuers without securities that are so listed, most state securities laws contain an exemption from registration for reoffers and resales made to QIBs within the meaning of Rule 144A or an institutional investor exemption broad enough to encompass QIBs.

Rule 144A offerings are also exempt from filing under FINRA's Corporate Financing Rule and FINRA's requirement to file private placement documents.

Financial institution and insurance company issuers often use Rule 144A continuous issuance programs for multiple offerings (usually of debt securities) to potential offerees. Rule 144A programs are generally similar to "medium-term note programs," but they are sold only to QIBs.

Eligible Purchasers

As a condition of Rule 144A, the resale may be made to a purchaser that the reseller (and any person acting on its behalf) reasonably believes is a QIB. A QIB is an institution (not a natural person), foreign or domestic, included within one of the categories of institutional "accredited investors" defined in Rule 501 of Regulation D, acting for its own account or the accounts of other QIBs that meets certain financial thresholds (outlined in greater detail below). A reasonable belief that the purchaser is a QIB may be established based on a QIB representation letter or based on recent financial information about the entity. Recent financial information may include publicly available annual financial statements, information filed with a governmental agency or self-regulatory organization, a certification by the entity's chief financial or other executive officer, or information in a recognized securities manual, in each case, as of a date not more than 16 months for a domestic entity or 18 months for a foreign entity preceding the sale.

To be considered a QIB, an entity must also, in the aggregate, own and invest on a discretionary basis at least $100 million in securities ($10 million for a broker-dealer) of issuers not affiliated with the entity. QIBs that are banks and savings and loan associations must also have a net worth of at least $25 million. Entities formed solely for the purpose of acquiring restricted securities in a Rule 144A transaction will be QIBs, provided that they satisfy the QIB requirements.

To determine whether an entity owns and invests the requisite amount of securities, the value of the securities is typically calculated on a cost basis. However, an entity may use fair market value basis where it does so for financial reporting purposes and no current information with respect to the cost of such securities has been published. If an entity reports both cost and fair market values of the securities it holds, only the cost valuation method will be used to determine whether that entity is a QIB. The value of the securities to be purchased in the Rule 144A transaction may not be included in an entity's aggregate total, and bank deposit notes, certificates of deposit, loan participations, repurchase agreements, and currency, interest rate, and commodity swaps must also be excluded. Securities held by an entity's consolidated subsidiaries may be included if such securities are managed by that entity and either (i) the entity is a reporting company under the Securities Exchange Act of 1934 (the "Exchange Act") or (ii) the

entity itself is not a majority-owned subsidiary that would be included in the consolidated financial statements of another enterprise.

A broker-dealer acting as a riskless principal for a QIB will also be deemed to be a QIB. In a riskless principal transaction, the broker-dealer must have a commitment from its customer, the QIB, that it will simultaneously purchase the securities from the broker-dealer. This commitment must be in place at the time of purchase in the Rule 144A transaction.

In establishing a reasonable belief that a potential purchaser is a QIB, a seller has no obligation to confirm the validity of any information and may rely on available information that shows an entity is a QIB, even where more recent information is available (including where the more recent information indicates that a purchaser now holds fewer securities). However, a seller cannot rely on information or certifications that it knows, or is reckless in not knowing, are false.

Eligible Securities

The eligibility of the securities that can be offered in reliance on Rule 144A is determined at time of issuance. To rely on Rule 144A, the securities must not be fungible with a class of securities listed on a U.S. national securities exchange or quoted on a U.S. automated inter-dealer quotation system, and must not be securities of an open-end investment company, unit investment trust, or face-amount certificate company that is, or is required to be, registered under the Investment Company Act of 1940. Because eligibility for Rule 144A purposes is determined at the time of issuance, securities of the same class that are thereafter listed will not affect Rule 144A eligibility.

Whether a security is deemed to be fungible with or of the same class as listed securities depends on the type of security:

- Common stock, preferred stock, and debt securities are deemed to be of the same class if the material terms and the rights and the privileges of the holders of the class of securities are substantially the same as those of the listed securities. American Depositary Receipts ("ADRs") are of the same class as the underlying securities.
- Warrants with a term less than three years or an effective exercise premium at pricing of the Rule 144A offering of less than 10% will be treated as the same class as the underlying security. The exercise premium is calculated by: (i) taking its price at issuance; (ii) adding to such price its aggregate exercise price; (iii) subtracting from such number the aggregate market value (as of the pricing day of the warrants) of the securities that would be received on exercise; and (vi) dividing the difference by the amount subtracted in (iii).
- Convertible or exchangeable securities with an effective conversion premium at pricing of the Rule 144A offering of less than 10% are considered to be of the same class as the underlying security. The effective conversion premium is calculated by: (i) taking its price at issuance; (ii) subtracting from such price the aggregate market value (as of the pricing day of the convertible securities) of the securities that would be received on conversion; and (iii) dividing the difference by the amount subtracted in (ii).

As described above, securities acquired in a Rule 144A resale are deemed to be "restricted securities" within the meaning of Rule 144(a)(3) of the Securities Act; i.e., they are not freely tradeable absent an exemption or registration of the resale under the Securities Act until the end of the applicable holding

period under Rule 144. A six-month holding period is required for restricted securities of an issuer that has been a reporting company under the Exchange Act for at least 90 days and is current in those reporting obligations at the time of sale. A one-year holding period is required for restricted securities of a non-reporting company or a reporting company that is not current in its reporting obligations at the time of sale. As a result of the limitations on resale, and the related reduction in liquidity, the seller must make the purchaser aware that the securities are being sold pursuant to Rule 144A. Typically this is achieved by placing a legend on the security itself and including appropriate notice in the offering documentation. The securities will also be assigned a restricted CUSIP number.

Conducting Traditional Rule 144A Transactions

Rule 144A Offering Process

The Rule 144A offering process is often similar to the public offering process. Typically, a "red herring," or preliminary offering memorandum, is distributed to investors for the purpose of soliciting orders. Once the offering prices, a final term sheet is delivered to investors to indicate the final pricing terms and confirm orders. The comfort letter from the issuer's auditors will also be delivered to the initial purchasers at pricing. The closing usually takes place three to five days after pricing. The legal opinions and other closing documents will be delivered at closing.

Rule 144A Offering Documentation

Unlike SEC-registered offerings, there are no specific SEC disclosure requirements for Rule 144A offerings. However, to avoid potential liability to the initial purchasers, Rule 144A offering documents are quite similar to the prospectuses prepared for SEC-registered offerings in terms of the scope and depth of disclosure. The documentation used in a Rule 144A transactions is also similar to that used in registered offerings, and includes:

- An offering memorandum, which typically contains a detailed description of the issuer, including its business and financial results, and the details of the securities to be offered, as well as risk factors, a discussion of the issuer's management, tax considerations, and other matters. If the issuer is an Exchange Act reporting company, the offering memorandum will incorporate by reference the issuer's Exchange Act filings, making the document significantly shorter. The offering memorandum will also include an appropriate notice to the investors regarding the restricted nature of the 144A securities and a section detailing transfer restrictions.
- A purchase agreement between the issuer and the initial purchasers that provides that the initial purchasers (equivalent to underwriters in a registered offering) may directly or through U.S. broker-dealer affiliates arrange for the offer and resale of securities within the United States only to QIBs pursuant to Rule 144A. The form, organization, and content of the purchase agreement often resembles an underwriting agreement for a public offering in many respects, but is modified to reflect the manner of offering.
- In some cases, a registration rights agreement between the issuer and the initial purchasers will also be executed by the parties. Occasionally, purchasers may require registration rights. The two principal methods to register Rule 144A securities under the Securities Act are Exxon Capital exchange offers and resale shelf registrations under Rule 415 of the Securities Act. Because of

certain administrative issues, Exxon Capital exchange offers are the preferred means for providing holders of Rule 144A securities with freely tradable securities.

- Closing documents, including legal opinions, comfort letters, officer's and secretary's certificates, and other customary deliverables will also accompany an offering.

Information Required to be Delivered for Non-Reporting Issuers

Specific information is required to be delivered to the purchasers under Rule 144A if the issuer is not a reporting company under the Exchange Act, a foreign company exempt from reporting under Rule 12g3-2(b), or a foreign government. In those cases, the holder of the securities and any prospective purchaser designated by the holder must have the right to obtain from the issuer, upon request, a brief description of the issuer's business, products, and services and the issuer's most recent audited financial statements. The information provided must be "reasonably current" in relation to the date of resale under Rule 144A, generally as of a date within 12 months prior to the resale for U.S. issuers and within the timing requirements imposed by the jurisdiction of a non-U.S. issuer. This right to information, required under Rule 144A, is agreed to by the issuer with the initial purchasers in the purchase agreement.

Rule 144A Offering Liability and Due Diligence Investigation

Although initial purchasers and issuers in a Rule 144A offering are not subject to liability under Section 11 of the Securities Act, they could be subject to liability for material misstatements and omissions under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. As a result of potential liability under Section 10(b) and Rule 10b-5, an offering memorandum for a Rule 144A offering usually contains information comparable to what a prospectus for a registered offering would contain.

The "due diligence" defense for underwriters that may be established under Section 11 of the Securities Act (but not issuers, who are strictly liable) is only applicable to registered offerings, not Rule 144A offerings. Nonetheless, a due diligence investigation will result in better and more thorough disclosure, and also enables the initial purchaser to evaluate the relevant risks and to decide whether to undertake an offering.

As with a registered offering, the Rule 144A due diligence process consists of business and management due diligence and documentary (or legal) due diligence. The initial purchasers in a Rule 144A offering and their counsel will conduct a review of the issuer's public filings and other publicly available information; verify company information through independent sources; undertake a close review of the issuer's financial statements, corporate documents, and key contracts; conduct interviews with management, key employees, and site visits; and obtain appropriate legal opinions and comfort letters.

Rule 159 Under the Securities Act

Rule 159 provides that the adequacy of the disclosure in a prospectus is evaluated as of the time that an investor forms a contract to purchase the securities and that no information provided after that time may be considered for purposes of liability determinations with respect any misstatements or omissions in the offering materials.

As a general practice, the purchase contract is usually delivered before the final prospectus. To meet the Rule 159 standard, in registered offerings, especially in debt offerings, the issuer or the underwriters usually provide investors with a final term sheet or similar document with the information that was not included in the preliminary prospectus, such as pricing-specific information or corrections to the

preliminary prospectus at the time of pricing. Although Rule 159 only applies to registered public offerings, Rule 144A offerings tend to adopt this practice, including the delivery of term sheets and required statements in legal opinions and officer certificates, based on concerns that a court could apply a similar standard in evaluating the sufficiency of disclosure in a Rule 144A offering.

Concurrent Regulation S Offering

Regulation S under the Securities Act provides another exemption from the registration requirements of the Securities Act. Regulation S applies to securities offered and sold outside the U.S. to non-U.S. persons. It is very common to have a Rule 144A tranche offered to QIBs and a Regulation S tranche offered to non-U.S. purchasers. In order to ensure lawful transfer in the secondary market, these tranches are usually represented by separate global certificates because Regulation S debt securities usually have a restricted holding period that is shorter than the Rule 144 holding period. In such a case, the Rule 144A global certificate with a Rule 144A restrictive legend is deposited with The Depository Trust Company ("DTC"), while the Regulation S global certificate with a Regulation S restrictive legend is deposited with a European clearing system. The Rule 144A securities can be re-sold to non-U.S. purchasers that are not QIBs if the sale complies with Regulation S. Similarly, the Regulation S securities can be re-sold in the U.S. to QIBs if the resale complies with Rule 144A. The registrar of the securities will track increases or decreases in the respective certificates.

Subsequent Registration

Securities sold pursuant to Rule 144A may be subsequently registered under the Securities Act pursuant to a registration rights agreement (as described above); however, it is also possible for an issuer to become obligated to register equity securities sold pursuant to Rule 144A even where a registration rights agreement was not executed in connection with the transaction.

Rule 144A Offering Market And Recent Trends

Rule 144A now permits general solicitation and general advertising, provided that actual sales are only made to persons that are reasonably believed to be QIBs. Consequently, prior practices for Rule 144A offerings, such as internet road shows available to QIBs only and using password protection, are no longer technically required, although initial purchasers continue to limit the use of general solicitation. For Regulation S offerings with a Rule 144A tranche, general solicitation and general advertising in connection with the Rule 144A tranche will not be viewed by the SEC as "directed selling efforts" in connection with the concurrent Regulation S offering.

Checklist of Key Questions

- Is the security eligible for Rule 144A?
- Are the purchasers QIBs?
- Will the Rule 144A offering be made concurrent with a Regulation S offering?
- Is the issuer an Exchange Act reporting company? If not, will the issuer be able to provide the required information to investors following the offering?
- What type of offering is contemplated – is it a Rule 144A for life offering? A traditional Rule 144A offering?
- Will the issuer commit to provide registration rights?
- Has diligence satisfactory to the initial purchasers been conducted?
- Will the issuer offer securities contemporaneously in a private placement?