Foreign Private Issuer Exemption from SEC Registration: Practical Implications

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On August 27, 2008, the U.S. Securities and Exchange Commission adopted rule amendments that will automatically exempt thousands of non-U.S. companies from SEC registration and, as a result, from the Sarbanes-Oxley Act of 2002. The amendments to the 40-year old Rule 12g3-2(b), which will become effective on October 10, 2008, will exempt from registration most non-U.S. companies that are listed in their home markets (but not in the United States), and that publish certain English language financial and business information on their websites.

Many of the newly exempt companies are probably unaware they need an exemption. Under a complex web of interlocking statutory and regulatory provisions, non-U.S. companies with more than 300 U.S. shareholders generally require an exemption to avoid the SEC registration requirement. The explosion of global trading in recent years has caused many companies to exceed the 300 U.S. shareholder threshold, and most have not applied for an exemption, although the SEC has not enforced the registration requirement strictly. The amendment will allow these companies to benefit automatically from an exemption, rather than relying on the SEC's enforcement discretion.

While the amendments are a favorable development for non-U.S. companies, they raise a number of practical issues. Companies that are exempt under the old rule may need to change their communication practices to conform to the requirements of the amended rule. Other companies may also need to consider whether their current practices allow them to qualify for the exemption. The rule amendments may also have significant implications for the way in which shares of non-U.S. companies trade in the U.S. over-the-counter market by facilitating the creation of more "unsponsored" ADR programs. They also could affect practices for securities offerings to institutional investors in the United States.

This memorandum explains how Rule 12g3-2(b) works and discusses the principal implications of the new amendments for non-U.S. companies.

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1. Rule 12g3-2(b) and the New Amendments

History and Functioning of Rule 12g3-2(b)

The SEC adopted Rule 12g3-2(b) in 1967, as an exemption from a registration requirement that was adopted by the U.S. Congress in 1964. Under Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act"), all companies with at least 500 shareholders of record and at least $10 million[1] of assets must register with the SEC and file periodic reports containing information relating to their business, financial condition, management and other matters. The purpose of this requirement is to ensure that all companies with a certain level of public shareholder interest provide information to the market, even if they have not publicly offered or listed their securities in the United States. Registered companies also must comply with the Sarbanes-Oxley Act of 2002.

In an initial draft of Section 12(g), Congress proposed to exempt all non-U.S. companies (known as "foreign private issuers," or "FPIs") from the registration and reporting requirement, giving the SEC the power to subject FPIs to registration and reporting in appropriate cases. In the final version, the situation was reversed (apparently for procedural reasons, according to the legislative history), with both U.S. companies and FPIs being subject to Section 12(g), but the SEC having broad powers to exempt FPIs.

After initially adopting a temporary exemption for all FPIs, the SEC adopted two permanent exemptions from Section 12(g) for FPIs that do not list or publicly offer securities in the United States. The first was Section 12g3-2(a), which exempts FPIs with 300 or fewer U.S. shareholders from the registration requirement. The second was Section 12g3-2(b), which exempts FPIs that submit to the SEC English translations, versions or summaries of the documents that they publish in their home markets or distribute to shareholders.

In the market as it existed in the 1960s, the 300 U.S. shareholder threshold of Rule 12g3-2(a) was sufficient to exempt substantially all FPIs from registration, except those that created ADR facilities[2] or otherwise took voluntary steps to create U.S. investor interest for their shares. At the time, there was relatively little U.S. investor

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[1] The threshold in Section 12(g) is $1 million in total assets, but this has been increased to $10 million under rule 12g-1 under the Exchange Act.

[2] An ADR facility is a program established by a U.S. bank, which issues certificates (American Depositary Receipts, or ADRs) that represent ownership interests in shares of a non-U.S. company that are deposited with the bank. The ADRs trade in U.S. dollars and clear through The Depository Trust Company (the principal U.S. clearing system), and the bank typically provides services such as converting dividends to U.S. dollars and forwarding reports and notices to investors. An ADR facility may be established without an offering or listing by the subject company in order to facilitate trading by U.S. shareholders (a "Level 1" facility), or in connection with a public offering or listing.

interest in securities of FPIs, and few FPIs would have exceeded the 300 U.S. shareholder threshold involuntarily.

Rule 12g3-2(b) was traditionally used by companies that sought to establish ADR facilities to promote U.S. trading in their shares. The exemption was (and still is) a prerequisite for the establishment of an unrestricted ADR facility by a bank in respect of an unregistered company. To establish the exemption, a company simply sent a letter to the SEC describing the documents it publishes in its home market and furnishing other information, and providing English translations, versions or summaries (depending on the type of document) of the documents published since the end of its most recent fiscal year. To maintain the exemption, it was required to continue to submit the same documents following home country publication.

More than forty years later, the original exemptions are out of date. In a world with global, internet-based trading, many companies have more than 300 U.S. shareholders, even if they have minimal U.S. connections, as U.S. shareholders often trade shares in their home markets. Moreover, shares are often held through brokers and other intermediaries, making it impossible for many companies to count their U.S. shareholders. As a result, many companies no longer qualify for the exemption provided by Rule 12g3-2(a).

Many of these companies are eligible for exemption under Rule 12g3-2(b). Unlike the 300 U.S. shareholder exemption, however, Rule 12g3-2(b) in its original version required companies to take affirmative steps such as applying for the exemption and sending documents to the SEC on an ongoing basis (in paper form, for most companies). As a result, Rule 12g3-2(b) does not work for companies that are unaware that they need an exemption, or that are reluctant to accept the administrative burdens of establishing and maintaining the exemption.

The New Amendments

The SEC adopted the new amendments in order to modernize Rule 12g3-2(b). In contrast to the original rule, the amendments eliminate the requirement for a company to submit an application, and they substitute electronic publication for the delivery of paper documents to the SEC.

Under the amended version of Rule 12g3-2(b), an FPI is exempt from the registration requirement of Section 12(g) if:

- It has no active Exchange Act reporting obligations under Section 13(a) or 15(d) (this means essentially that the FPI has not listed or publicly offered securities in the United States).

- It maintains a listing of its shares[3] on one or more non-U.S. exchanges that are its "primary trading market" (meaning one or two markets that together represent at least 55% of its worldwide trading volume, at least one of which must have greater trading volume than the United States).

- It publishes on its website,[4] in English, the material information that it makes public in its home country, files with the principal exchange(s) in its primary trading market, or distributes to its security holders. To establish the exemption initially, the FPI must electronically publish in English all of the relevant documents that it has published, filed or distributed since the beginning of its most recent fiscal year. Thereafter, the English documents must be published promptly after publication or distribution in the home market (the meaning of the term "promptly" for these purposes is discussed below).

The amendments do not include the most controversial eligibility requirement that the SEC initially proposed in February 2008, when it solicited public comment on proposed amendments to Rule 12g3-2(b). The February proposal would have made an FPI ineligible for the exemption if trading in the United States represented more than 20% of its worldwide trading volume in the most recently completed year. In the release accompanying the final amendments, the SEC indicated that most commenters had opposed the 20% trading volume test, because it would have discouraged companies from establishing sponsored ADR programs or engaging in activities that might stimulate U.S. trading. As the FPI must still meet the "primary trading market" requirement described above in order to benefit from the exemption, U.S. trading must in any case represent no more than 45% of its worldwide trading volume.

2. Implications for FPIs

The amendments will to a large extent restore the situation that existed in the 1960s when Rule 12g3-2(a) and (b) were first adopted, because many FPIs will be exempt from registration under the amended rule simply by following their ordinary disclosure practices, in many cases without even being aware of the exemption. Companies should nonetheless consider examining their current practices to determine whether modifications are necessary to allow them to comply with the new requirements

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[3] Section 12(g) applies to any "class" of equity securities, so that a company with both ordinary shares and preference shares would need to have a separate exemption for each class to avoid registration. In an instruction to amended Rule 12g3-2(b), the SEC has said that compensatory stock options are automatically exempt if the underlying shares are exempt, even if the options would otherwise constitute a separate "class." For simplicity, we generally refer in this memorandum to a company's shares, rather than to "classes" of equity securities.

[4] The amended rule also allows an issuer to publish the information through a freely accessible electronic delivery system established by a securities regulator. The SEC's release cited the Canadian SEDAR system as an example of such a system.

(companies that are exempt under the old rules will generally have to update their practices). A few companies might find it difficult to comply with the new rules, and will have to consider what steps they should take to address the situation.

In this section, we discuss what companies might consider doing to prepare for the effectiveness of the amendments, as well as some of the practical implications of the amendments for companies that become exempt.

A. FPIs Exempt under the Original Rule 12g3-2(b). Many companies that are currently exempt under Rule 12g3-2(b) will have to change their practices when the amendments become effective.[5] Fortunately, substantially all of these companies will find the burden of compliance to be significantly reduced, as they will no longer need to send paper documents to the SEC to maintain the exemption.

The amendments provide that FPIs that are currently exempt will have three months from the effective date of the amendments (i.e., until January 10, 2009) to switch to website publication. After this deadline, the SEC will no longer accept paper filings.

FPIs that are currently exempt should examine their practices to ensure that they comply with the new rules prior to this deadline (see the discussion below of practical guidance for all FPIs). Companies that are currently exempt but are unable to comply with the new requirements will have three years following the effective date of the amendments to register or to establish compliance (see the discussion below regarding companies that are unable to comply).

B. Practical Guidance for All FPIs. While the amendments have substantially simplified the Rule 12g3-2(b) exemption process by making it automatic and substituting electronic publication for paper document delivery, they do contain some important requirements that FPIs will need to consider to ensure they benefit from the exemptions. While most companies will be able to comply simply by following their ordinary disclosure practices, it would be prudent for companies to review those practices to ensure that the following issues are properly addressed:

- *Which documents must be published electronically?* The amendments have not changed the list of documents to be published electronically compared to the documents required to be submitted in paper form under the original rule. For most companies, the documents to be published electronically will include annual and interim reports, financial statements, notices of shareholder meetings, resolutions and material press releases. The amended rule continues to provide that only "material" information must be published.

[5] Companies that are exempt under Rule 12g3-2(b) following deregistration will not need to change their practices, as the amendments effectively replicate the requirements that became applicable to deregistering companies in June 2007, when the deregistration rules became effective. In addition, some companies that were otherwise exempt have already switched from paper submission to website publication under an option that was made available in June 2007.

Under the U.S. securities laws, information is generally considered "material" if it changes the overall mix of information available to the market, and if a reasonable investor would consider it important in making an investment decision. The amended rule provides a non-exhaustive list of information that would ordinarily be material, including information concerning: (i) results of operations or financial condition, (ii) changes in business, (iii) acquisitions or dispositions of assets, (iv) issuance, redemption or acquisition of securities, (v) changes in management or control, (vi) granting of options or payment of other remuneration to directors or officers, and (vii) transactions with directors, officers or principal security holders.

- *Which documents must be translated into English*? Unlike the original rule, the amendments specifically require that an FPI publish translations, rather than summaries or English "versions," of its annual report and financial statements, its interim reports that include financial statements, press releases and communications and documents distributed directly to shareholders. The translation requirement could raise issues for some FPIs. For example, an annual report may contain information that is not "material" to U.S. investors (unconsolidated parent company financial statements, information for employees, description of tax consequences for home country investors, sustainable development information). Non-material information is not required to be published at all; based on an informal conversation with the SEC staff, we believe that an FPI can omit non-material information from an English translation, even if it is included in the original language document. FPIs that regularly publish abridged English versions of their annual reports should consider whether the information they omit might be "material" information for U.S. investors.

- *When must the English documents be published?* Similar to the original rule, the amendments require an FPI to publish the English documents "promptly" after the original document is published. The SEC did not define the term "promptly," but stated in the release accompanying the final rule that this will depend on the type of document and the amount of time required to prepare an English translation. It said that an FPI must publish a material press release "on or around" the same business day on which the original language document is published.

- *Where on the website should documents be published?* The rule does not specify any particular location on an FPI's website, although most companies would ordinarily publish the information on an investor relations or financial communications page. Some companies that currently use website publication[6] have set up dedicated Rule 12g3-2(b) pages with links to the

[6] As noted above, FPIs have had the option of using website publication since June 2007.

relevant documents. While this is not required, it may be useful to demonstrate compliance or to ensure that the responsible people do not forget to publish the required documents in English if they would not otherwise do so.

- *What happens if an FPI fails to publish a required document?* The SEC has not provided any cure period for FPIs that fail to make required publications. However, in the release accompanying the final rule the SEC said that a company must either re-establish compliance "in a reasonably prompt manner" or else register under the Exchange Act. Presumably, the SEC will take a common sense approach, particularly in cases of inadvertent failure to comply with the rule (as it has done in the past for companies that have neglected to make required paper filings).

C. *Implications for ADR Facilities*. As mentioned above, the SEC's rules only allow a bank to establish an unrestricted ADR facility if either the issuer of the underlying shares is a reporting company, or the shares are exempt from registration under Rule 12g3-2(b). Because the amendments will automatically extend the Rule 12g3-2(b) exemption to vast numbers of FPIs, they will also automatically increase the number of FPIs whose shares will be eligible for ADR facilities.

While this will make it easier for FPIs to establish "sponsored" ADR facilities (which are established pursuant to an agreement between an FPI and a depositary bank), it will also make it easier for banks to establish "unsponsored" ADR facilities (which banks can establish without such an agreement). Previously, a bank had to obtain cooperation from an FPI before establishing an unsponsored ADR facility, because the FPI had to apply for the Rule 12g3-2(b) exemption to allow the bank to set up the ADR facility. Because many companies will be automatically exempt under the amendments, their cooperation will no longer be necessary to allow banks to establish unsponsored ADR facilities.

While some commenters on the SEC's February 2008 proposal (including our firm) suggested that the SEC require a bank to notify an FPI or obtain its consent before establishing an unsponsored ADR facility, the final rule does not contain such a requirement. Most ADR depositary banks say that they regularly provide such notice as part of their commercial policies, and that they do not establish the ADR facilities when the FPI objects.[7]

Easing the creation of unsponsored ADR facilities might be a positive development for some companies, which could see increased interest in their shares on

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[7] The staff of the SEC has indicated to us that the consent requirement was not adopted because it seemed unnecessary in light of market practice of depositary banks to decline to establish an ADR facility when an issuer has objected. The staff indicated they might revisit this conclusion if depositary banks did not continue to follow this practice.

the part of U.S. investors who prefer (or are required) to hold shares in the form of ADRs. On the other hand, some companies might not view this as a positive development, for the following reasons:

- The SEC's policy is that companies may not establish sponsored ADRs when there is an unsponsored ADR facility outstanding.[8] If a company with an unsponsored ADR facility decides in the future to establish a sponsored facility, it will have to arrange for the unsponsored facility to be terminated, which typically requires the payment of fees (usually by the newly appointed depositary bank) to the bank that establishes the unsponsored ADR facility (unless the same bank is used for the sponsored facility). If these fees are paid by the newly appointed depositary bank, they could reduce the amount that bank is willing to pay the company in connection with establishing the sponsored facility.

- Some companies might prefer not to have the additional U.S. investor interest that an unsponsored ADR facility would create.

- Unlike banks that enter into agreements for sponsored facilities, those that set up unsponsored facilities typically do not undertake to provide information about the ADR holders to the FPIs. This means that FPIs might lose contact with part of their shareholder base. The problem is particularly significant in some civil law jurisdictions, where the ADR depositary bank is considered the sole owner of the shares underlying the ADRs, with the result that the ultimate holders do not file ownership reports with regulators or issuers when they accumulate positions in a company's stock.

There is not much that FPIs can do to avoid the establishment of unsponsored ADR facilities, other than taking intentional steps to avoid becoming eligible for Rule 12g3-2(b) (for example, by omitting to publish material information on their websites in English). Presumably, most companies will not want to do this. FPIs could set up sponsored ADR programs as a defensive measure (because the SEC’s policy is also to prohibit unsponsored facilities when sponsored facilities exist), although this might be contrary to the strategy of some companies with respect to their shareholder base.

D. Issues for U.S. Institutional Securities Offerings. The rule amendments may require some changes to practices in connection with offerings of shares of exempt FPIs to U.S. institutional investors, including the following:

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[8] The SEC’s policy is reflected in a 1991 release on the functioning of the ADR market. See. SEC Release Nos. 33-6894 and 34-29226 (May 23, 1991). The release did not result in the adoption of any new rules, nor did a subsequent release issued in 2003. See SEC Release Nos. 33-8287 and 34-48482 (September 11, 2003). Based on a recent informal conversation with the staff, we understand that the SEC continues to take the position that it will not permit a sponsored ADR facility to co-exist with an unsponsored ADR facility relating to the same underlying shares.

- Exempt companies will be required to publish on their websites in English press releases announcing share offerings. These press releases will need to be reviewed carefully to ensure that their publication does not constitute a "general solicitation" or "directed selling efforts" in the United States in connection with the offerings. Traditionally, FPIs have refrained from posting English language press releases on their websites, or have restricted access to those press releases, in order to avoid this issue, but this practice will no longer be possible for material press releases. FPIs that are exempt under Rule 12g3-2(b) may publish press releases relating to offerings in the United States (and on their websites) pursuant to Rule 135c under the Securities Act of 1933, but the information contained in those press releases must be limited, and in particular the press releases may not include the names of the underwriters for the offering. FPIs that decide to limit their English language press releases to the information permitted by Rule 135c (or FPIs from English-speaking countries that limit the website versions of their press releases in this manner) will need to conclude that any additional information contained in original press releases is not material, and thus is not required to be published to maintain the Rule 12g3-2(b) exemption.[9]

- Significant shareholders will more easily be able to sell shares of exempt FPIs to U.S. "qualified institutional buyers" (generally, institutions that own or manage at least $100 million in securities) pursuant to Rule 144A under the Securities Act. Rule 144A requires, among other things, that the issuer undertake to provide basic business and financial information to investors if the issuer is not exempt under Rule 12g3-2(b). Selling shareholders have in many cases been unable to use Rule 144A in transactions where the issuer does not participate, because they are unable to obtain the required undertaking. For sales of shares of companies that become exempt under the amendments to Rule 12g3-2(b), the undertaking will no longer be necessary. However, the selling shareholder (and any investment bank that assists in the placement) will need to confirm that the issuer is in compliance with the requirements of Rule 12g3-2(b) to proceed on this basis.[10]

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[9] FPIs that conduct securities offerings may also publish press releases outside the United States pursuant to Rule 135e under the Securities Act, which does not contain content limitations. It is customary in some jurisdictions to include the names of the underwriters and other information in home country press releases. However, FPIs typically do not publish these press releases on their websites (or else they restrict access to non-U.S. readers) to avoid the risk of losing their Securities Act exemption. With the adoption of the Rule 12g3-2(b) amendments, FPIs must either limit the contents of their home country press releases to the information permitted by Rule 135c, or publish two separate press releases, one for distribution outside the United States pursuant to Rule 135e, and the other for website publication, containing only the information permitted by Rule 135c.

[10] The SEC stated in the release accompanying the final amendments that it will stop publishing a list of FPIs that are exempt under Rule 12g3-2(b). As a result, market participants will not be

E. Issues for Companies that are Unable to Establish Compliance. While the vast majority of FPIs will be able to comply with the requirements of the amended Rule 12g3-2(b) exemption without significant difficulty, a few FPIs may find they are unable to comply. For example, a company that does not publish an English translation of its annual or interim report will not qualify for the exemption, and could be subject to a registration requirement if significant numbers of U.S. investors purchase shares in its home market.

The problem is probably most likely to arise with respect to non-U.S. private funds. A private offshore fund that is not listed may have a significant U.S. institutional shareholder base, [11] but would not qualify for Rule 12g3-2(b) because it is not listed. Even if it is listed, if there is not significant trading in the fund's shares, it is possible that a handful of U.S. institutional trades will represent more than 45% of its worldwide trading volume, disqualifying it for the exemption.

FPIs that are exempt under the current version of Rule 12g3-2(b), but that would not be exempt under the amended rule, will have three years to establish compliance or register. FPIs that are not exempt under the current rule do not have a transition period.

FPIs that find themselves unable to comply will have to consider a number of options, including listing on a non-U.S. exchange (if this is not already the case), or taking steps to limit the number of their U.S. shareholders or trading among U.S. shareholders. They can also apply to the SEC for an individual exemption from registration, although the process could be long and complex, with no guarantee of a successful result. Otherwise, they will need to register with the SEC or face a risk of possible enforcement action.

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able to know that an FPI is exempt, unless they analyze the FPI's trading volume and English language publications to determine whether the FPI complies with the rule. The SEC adopted an instruction allowing depositary banks registering unsponsored ADR facilities to rely on reasonable, good faith belief after exercising reasonable due diligence, but it did not do the same for other third parties, such as selling shareholders relying on Rule 144A. While in many cases it will be relatively clear that an FPI qualifies for the exemption, it is likely that U.S. law firms will need to make assumptions (or rely on selling shareholder representations) as to factual matters and home country publication requirements in order to give no-registration opinions on the basis of Rule 144A where the issuer does not participate.

[11] Such a fund would need to be structured to ensure compliance with the Investment Company Act of 1940, for example by limiting offers and sales to U.S. investors to "qualified purchasers" and following certain procedures to monitor resales in the United States.

Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Capital Markets in the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

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