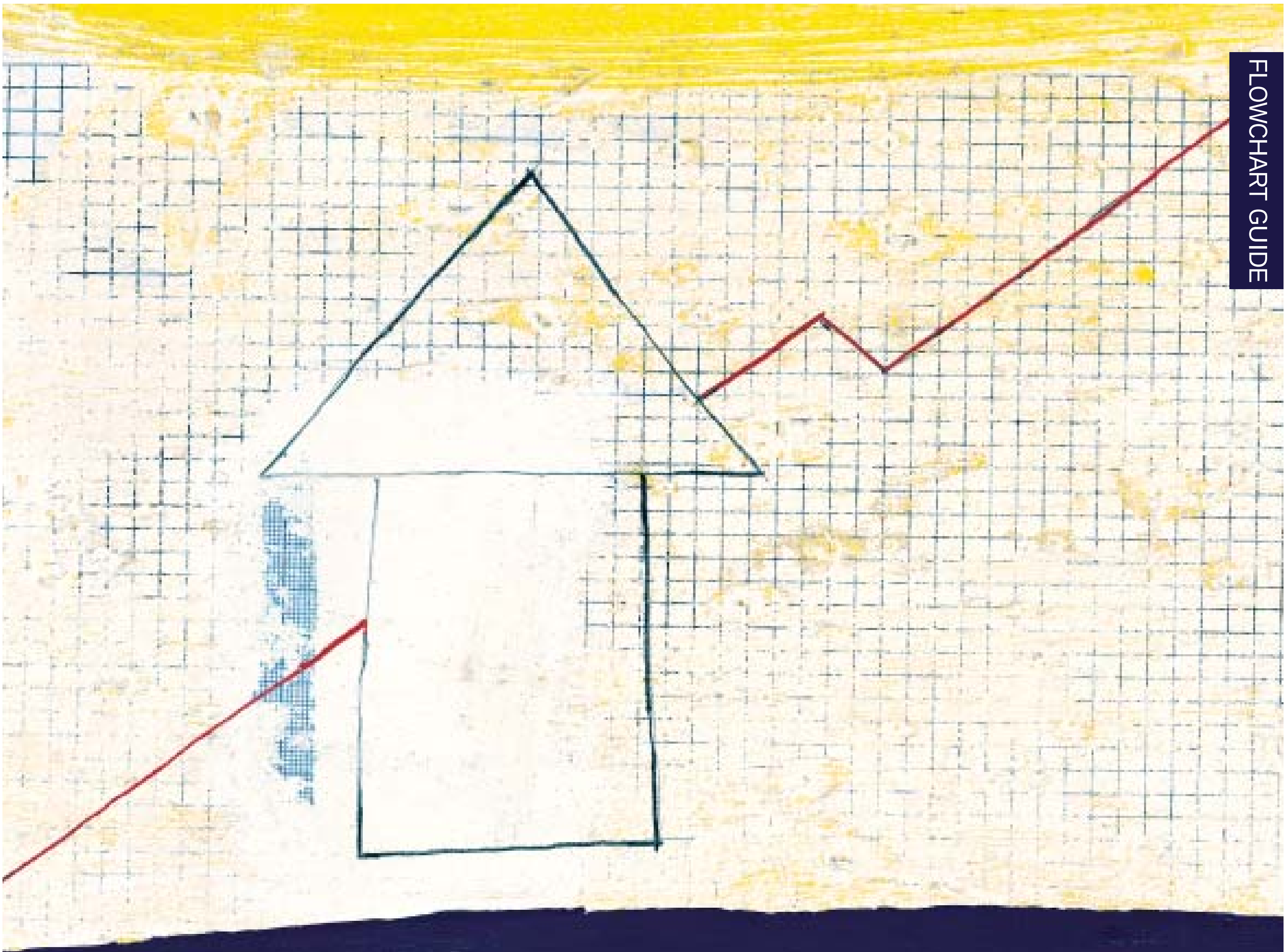

Company size and SEC registration

Sandra Folsom KINSEY explains how non-US companies can avoid triggering an unintended obligation to register with the SEC.

There are three situations in which a non-US company is required to register with the US Securities and Exchange Commission (SEC):

- Offering securities to the US public.
- Listing on a US stock market.
- Where the company reaches a certain size and has widespread share ownership in the US.

The first two are within a company's control and only occur at the company's instigation. The third scenario, however, may arise unintentionally, even if the company has made no effort to enter the US capital markets.

Any non-US company therefore needs to be aware of:

- The circumstances in which it may have to register with the SEC.

PLC Global Counsel

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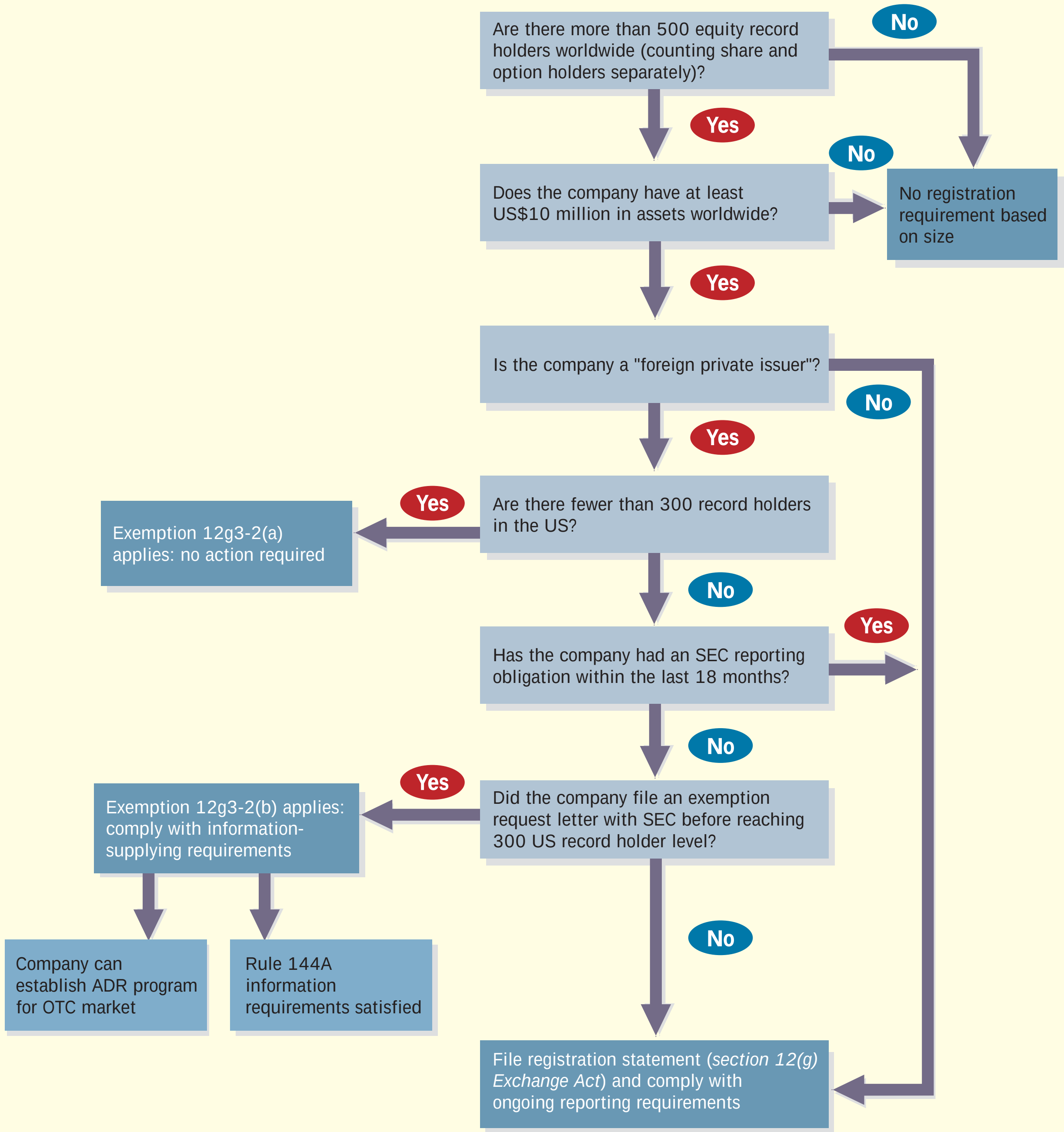
Non-US companies: Does the SEC size registration requirement apply?



- The exemptions available and the action the company can take in advance to avoid becoming subject to the SEC's size registration requirement and having to provide reports in the US.

Registration requirements

Offerings or listings. Like most major capital markets, the US requires companies that want to offer securities to the public or list securities on a formal, regulated market to make certain filings with the appropriate regulatory authority or exchange.

The main filing is a "registration statement" that contains extensive information about the company, its management, and the terms of the securities being offered or listed:

- In the case of a public offering, the registration statement also includes the plan for distributing the securities and the intended use of offering proceeds, and the information is organized into a "prospectus", which is the part of the registration statement that is distributed to prospective investors.

- The same amount of detailed information is required regardless of whether the registration statement relates to debt securities, equity, or some combination of the two.

- The registration statement is filed with the SEC and is subject to review and comment by the SEC staff.

Once the SEC has completed its review and declared that a company's registration statement is "effective", the company has an ongoing obligation to file annual reports and other information with the SEC and to comply with SEC rules and regulations. There are significant legal penalties for companies that fail to file a registration statement when one is required, or fail to file required reports, or make false or misleading statements of material information (or omit material information) in any registration statement or report.

Registration based on size and presence in the US. Unlike most other major markets, however, the US also requires a company to file a registration statement and comply with the SEC's reporting obligations if it reaches a certain size and has widespread share ownership. This third type of registration obligation applies regardless of whether the company has made a public offering of securities or listed its shares on a US stock market. A company actually considering a future US offering or listing may lose control of the timing if it finds itself required to register before it is ready to do so.

Under Section 12(g) of the Securities Exchange Act of 1934 (the Exchange Act), a company must register a class of equity securities with the SEC if, at the end of its last fiscal year:

- There were 500 or more holders of that class of securities listed in the company's share registry; and

- The company had more than US$10 million in assets worldwide.

The registration requirement applies to companies that:

- Are engaged in US "interstate commerce" or are in a business affecting US interstate commerce (this requirement is easily satisfied: virtually any business dealings in the US would be viewed as affecting interstate commerce); or

- Have securities traded by use of the US mails or any "means or instrumentality of interstate commerce." This phrase has traditionally included the US transportation and communication systems and, in the internet age, presumably also includes e-mails and other electronic communications.

The rationale for the Section 12(g) registration requirement is that when a company reaches a certain size and has widespread share ownership, it is, in effect, a "public" company and should be providing information to the investing public.

Many shareholders hold their shares through nominees or fiduciaries, so a company may have many beneficial holders and still have less than 500 nominal or record holders. Equally, however, a company could easily reach 500 or more shareholders, even if it has never made a public offering of its shares. For example, if the company has sold shares in private placement offerings or through granting options or shares to its employees, the shares may change hands and end up being owned by 500 or more holders. This trading takes place in the US' largely unregulated "over-the-counter" trading market. Companies that are required to register under Section 12(g) often follow that registration with a listing on a regulated market such as the OTC Bulletin Board, the Nasdaq Stock Market or a national exchange. However, if they do not meet the eligibility requirements for listing on a regulated market, their shares will continue to trade in the over-the-counter market.

Also, while the requirement applies only to holders of equity securities, the SEC interprets that term broadly to include options offered to employees to purchase equity securities for

Implications for options granted to US employees

Greater numbers of non-US companies now have operations located in the US and are interested in compensating their employees with options or other share incentives. Many of these companies have no desire to become subject to US federal securities laws and have taken care to avoid capital-raising activities in the US.

Non-US companies may view stock options purely as a compensation issue, and option grants may not be subject to registration under the securities laws of their home countries. Some non-US companies are aware that option grants may require registration in the US, but they rely on the availability of Rule 701 under the Securities Act of 1933 (the Securities Act) as a way of issuing options to their US employees without registration under that Act: companies that do not report under US federal securities laws may rely on the Rule 701 exemption from registration under the Securities Act for written compensatory benefit plans and contracts relating to share incentives for employees, officers, directors, general partners and consultants or advisors.

These companies may not realize, however, that their compensatory option grants may trigger SEC registration under the Exchange Act, even if they are exempt from registration under the Securities Act. Options are considered to be a distinct class of equity security (and option holders are counted separately from other shareholders in determining the number of US equity holders), but a company with many US employees holding options could still trigger Exchange Act registration even if it has few shareholders in the US (*see main text "Registration based on size and presence in the US"*).

compensatory purposes, thus expanding the possible classes of equity holders for the purposes of the rules (*see box "Implications for options granted to US employees"*).

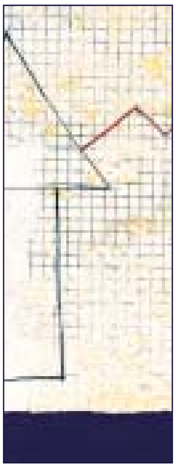
Impact on non-US companies. The reference to 500 holders of a company's equity securities is not limited to holders in the US. Without an exemption or other relief, the literal reach of Section 12(g) could require many non-US companies to register, even though few of their equity securities are held by US shareholders.

For non-US companies, registration under Section 12(g) requires the filing of a registration statement on Form 20-F and results in a continuing obligation to file reports with the SEC. Registration and reporting in the US are significant steps for any company, but can be particularly burdensome for a non-US company as it will essentially have to restate its financial statements to comply with US generally accepted accounting principles and provide different disclosure than is required in its home country.

Fortunately, the SEC realized the hardship Section 12(g) could impose on non-US companies and adopted a rule that limits the broad reach of the registration requirement. However, companies must take affirmative steps to claim the protection of the rule.

Exemptive relief

There are two exemptions from registration for "foreign private issuers" that do not intend to access the public securities markets in the US, but may be at risk of triggering the Section 12(g) registration requirement because of their asset size and number of shareholders or option holders (*Rule 12g3-2*). The term "foreign private issuer" has a special definition under US federal securities laws (for these purposes the word "private" means "non-governmental"). If a foreign company has too many shareholders or business contacts in the US, it will not satisfy the definition (*Rule 3b-4*).



The exemptions implicitly recognize that a non-US company's equity securities may end up in the US without the company's knowledge or assistance (such as through shareholder migration) or through private transactions that are not intended to affect the public US capital markets (such as through private placements or compensatory grants of securities):

- Complete exemptive relief is provided if only a small number of equity holders are located in the US.

- If a greater number of equity holders are in the US, more limited relief is provided, conditional on US shareholders having access to the same information that is available to non-US shareholders.

The specific criteria are as follows:

- *The first exemption.* A foreign private issuer that otherwise might be subject to the Section 12(g) registration and reporting requirements is automatically exempt so long as fewer than 300 "record" owners (i.e., owners listed in the company's share registry) of its equity securities are located in the US (*Rule 12g3-2(a)*). Companies must ask record owners who are broker-dealers, banks or nominees to provide the residency of the customers for whom they hold securities, and count any US customers toward the 300 threshold. Once the number of US equity holders reaches or exceeds 300, however – and assuming the company's assets and worldwide equity holders exceed the Section 12(g) limits – the company must register unless it has previously claimed the second exemption, which is described below.

- *The second exemption ("information-supplying").* If a company's equity holders in the US are likely to exceed 300, the company may claim exemptive relief so long as it provides certain information to the SEC and undertakes that it will continue providing similar company information in the future (*Rule 12g3-2(b)*). This relief is only available if the company has made no affirmative effort to enter the public capital markets in the US. Specifically, the exemption is not available if the company has had an effective registration statement or SEC reporting obligation within the past 18 months. Companies are not disqualified from relying on the exemption if they have offered securities in the US through private placements or under other exemptions.

The first exemption is available to any eligible company without that company having to take any action.

As a practical matter, many non-US companies probably are not even aware that they may be subject to a US registration obligation under Section 12(g) or that they have avoided that obligation because they are eligible for the automatic exemption in Subsection (a).

Once the number of US equity holders in a company approaches 300, however, the company must take affirmative action if it wishes to claim the relief available under the second exemption. Fortunately, claiming that exemption is relatively easy and is much quicker than a full SEC registration:

- The company must submit to the SEC staff an exemption request letter that sets out specific information including, among other things, the number of US record holders of the company's equity securities, the aggregate number of equity securities they hold and what percentage that represents of the total number of equity securities outstanding. The company also must explain, to the best of its knowledge, the circumstances under which the US holders obtained the securities.

- The request must include a listing of the disclosure obligations to which the company is subject in its home country, and copies of material documents the company has filed, made public or distributed to its shareholders outside the US during the past two completed fiscal years and any subsequent interim period.

- The company must undertake that it will continue making this kind of information publicly available in the US by "submitting" the information to the SEC, which for this purpose acts as a sort of public document repository. The information submitted for purposes of establishing and maintaining the exemption is not considered "filed" for filing liability purposes, although it is subject to the broad anti-fraud provisions of the US federal securities laws. (Complying with the requirements of Rule 12g3-2(b) does not constitute an admission that the company is subject to US securities laws.)

For this reason, the second exemption is sometimes referred to as the "information-supplying" exemption. The information does not have to be prepared to SEC specifications, and the content and timing of the submissions depend completely on what is disclosed in the home market. There is no requirement that the financial statements be prepared using US generally accepted accounting principles.

Claiming the second exemption and complying with its information requirements will protect a foreign private issuer from the registration and reporting requirements of Section 12(g) in the future, no matter how many of its equity holders are located in the US. However, the company must claim the information-supplying exemption before it reaches the level of 300 US equity holders, and it must take care to maintain the exemption continuously thereafter.

Positive aspects

Although the information-supplying exemption was intended to provide relief for non-US companies that inadvertently might trigger a Section 12(g) registration obligation, the exemption also provides other benefits:

• If a company has established the exemption, it is possible for an American Depositary Receipt (ADR) program to be established, either by the company itself (a sponsored program) or by a depositary bank acting on its own (an unsponsored program). The ADRs issued in this type of program may trade only in the US "over-the-counter" market. For ADRs to be listed on the OTC Bulletin Board, Nasdaq or a US national stock exchange, the underlying securities represented by the ADRs must be the subject of an effective SEC registration statement. Relying on the information-supplying exemption is not sufficient for trading in these more formal regulated markets. Some companies find it desirable to establish an over-the-counter ADR program to increase their visibility in the US or as a convenience for their US shareholders.

• A company making a Rule 144A private placement of its securities in the US must provide "reasonably current" information to the purchasers on request. The company is relieved of this requirement if it establishes and maintains the information-supplying exemption. Rule 144A provides that if a private placement is made only to "qualified institutional buyers" (QIBs), the securities may be traded freely to other QIBs as long as the requirements of Rule 144A are satisfied. QIBs and their prospective purchasers have the right to obtain "reasonably current" company information from the issuer of the securities, unless the issuer is a reporting company or provides information pursuant to the information-supplying exemption. Many issuers prefer to comply with the information-supplying exemption instead of responding to requests from QIBs and prospective purchasers, because they want to avoid the risk that someone will claim the right information was not provided or the information provided was not sufficiently current.

Some non-US companies find these benefits attractive enough that they will establish the information-supplying exemption even if the likelihood of having to register under Section 12(g) is remote.

Avoiding an unintended registration requirement

Any company with over US$10 million in assets and widespread share ownership should keep track of the number of record holders of its shares in the US, including a separate count of its option holders. If the number of record holders appears to be increasing, the company should begin the process of claiming the information-supplying exemption well before the number is likely to reach 300.

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Sandra Folsom Kinsey is a partner with Hogan & Hartson, L.L.P. Before joining the firm, Ms. Kinsey was Senior International Counsel with the SEC's Office of International Corporate Finance.