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Developments relating to Category 3 Offerings under Regulation S

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Regulation S requires U.S. and other Category 3 issuers seeking to make equity offerings abroad, among other things, to legend their share certificates as a means of enforcing the restrictions on resale to U.S. persons applicable during the period known as the "distribution compliance period." In practice, this provision has generally been applied to require the use of physical stock certificates, despite language in a 1998 Commission release to the effect that Category 3 securities may be issued in uncertificated form where issuers adequately put investors on notice of applicable resale restrictions. Category 3 also requires purchaser certifications and other measures designed to prevent an indirect, unregistered distribution of shares of these issuers in the United States. Different prophylactic measures are required in the case of debt securities.

Category 3 works uneasily, to say the least, with modern securities markets that mandate electronic settlement processes and dematerialization of shares. Indeed, the U.K.'s central securities depositary, Euroclear UK & Ireland (Euroclear), historically has declined to admit Category 3 securities to its systems. Early on, the SEC staff gave a few no-action letters (Australia, Easdaq and Stockholm) that attempted to adapt Category 3 to electronic settlement systems, but these letters were not interpreted to have applicability to other markets, were not updated and gradually fell into disuse.

Enter AIM, a market operated by the London Stock Exchange (LSE) generally for smaller or medium-sized enterprises, which through a derogation to its rules allowed U.S. companies to go public through its facilities in London with the use of physical stock certificates, manual purchaser certifications and the like. At one time, there were approximately 70 U.S. companies quoted on AIM, a number of which went public before the financial crisis, some to delay having to comply with SOX until later stages of their development. Although secondary market liquidity was impeded by the slow physical settlement process, AIM did at least provide a potential outlet for U.S. companies and other Category 3 equity issuers that sought an alternative to a registered U.S. public offering or a U.S. private placement. In part because of inefficiencies in physical settlement, though, the number of U.S. companies on AIM declined.

Other LSE markets, such as the Main Market (its flagship market for established companies) and its Specialist Fund Market (SFM) (aimed at highly specialized investment entities seeking institutional professional investors) proved less attractive to Category 3 equity issuers than AIM, presumably because of the liquidity issues. Few other foreign exchanges were able to accommodate physical settlement in view of their laws that required use of electronic settlement systems and dematerialization.

This state of affairs existed until quite recently. In the U.S. JOBS Act, enacted in 2012, Congress attempted to facilitate domestic IPOs by U.S. and foreign companies alike. In Title I of the JOBS Act, Congress attempted to facilitate domestic registered IPOs and, in Titles II-IV, domestic unregistered offerings. The legislative history of the JOBS Act reveals no congressional interest in facilitating offshore IPOs by American companies. The FAST Act, similarly, is focused on facilitating domestic securities offerings.

A European process, however, has shaken up the existing order. In 2014 the European Union adopted the Regulation on Central Securities Depositories that requires transactions in transferable securities taking place on EU regulated markets, such as the LSE's Main Market and SFM, and certain other trading facilities in the EU including AIM, to settle in book-entry form through a central securities depository. These requirements apply equally to securities issued by companies organized outside the EU. The use of physical stock settlements as a means of enabling offshore offerings of Category 3 securities on AIM has therefore become a relic of the past, due to changes in European Union law.

However, the LSE recently responded by amending its rules to facilitate offerings of Regulation S, Category 3 securities through its facilities. The LSE amended Rules 1550 and 5025 of its Core Rules and amended the Guidance to Rule 1550 to clarify the obligations of member firms trading Regulation S securities. Meanwhile, AIM published Notice 41 signifying that it would no longer grant derogations from AIM Rule 36 for Category 3 securities. AIM announced that as of September 1, 2015, it would expect Category 3 securities "to be eligible for electronic settlement within a CSD and therefore derogations will no longer be available from Rule 36 for such securities" (Rule 36 requires that securities be eligible for electronic settlement).

The LSE's actions occurred concurrently with changes to Euroclear's CREST manual designed to facilitate settlement of Category 3 securities in CREST, an electronic settlement system operated by Euroclear. The new procedures are intended to incorporate the legending, certification and stop transfer requirements of Category 3 into CREST. Where there is a transfer of securities between clients of a CREST participant, there would be no transfer on CREST's books, and in these circumstances the CREST member is solely responsible for complying with the transfer restrictions. To some extent, CREST and/or the LSE appeared conceptually to build upon the old settlement system for Regulation S securities developed for AIM by SegaInterSettle AG in 2006, which was hardly used, although this old system does not appear to have been discussed in the consultation process for the new rules.

The LSE is hopeful that the new electronic trading settlement of Category 3 securities will allow for increased liquidity and prove an attractive option for U.S. issuers looking to raise capital in London. It should be noted, however, that issuers, distributors and CREST members will ultimately retain responsibility for ensuring that the new provisions, in the individual circumstances of each transaction, are sufficient to satisfy applicable legal requirements. The new Regulation S system includes a disclaimer to this effect.

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