# FREQUENTLY ASKED QUESTIONS ABOUT BOUGHT DEALS AND BLOCK TRADES

## Bought Deals

***What is a "bought deal"?***

In a typical underwritten offering of securities, the underwriters will engage in a confidential (in the case of a wall-crossed or pre-marketed offering) and/or a public marketing period (which may be quite abbreviated) to build a "book" and price the offering of securities. In a traditional underwritten offering, the underwriters will have an opportunity to market the offering and obtain indications of interest from investors before the underwriters enter into the underwriting agreement with the issuer.

By contrast, in a "bought deal" (sometimes also referred to as an "overnight deal"), the issuer usually will establish a competitive "bid" process and solicit bids from multiple underwriters familiar with the issuer and its business. The bidding underwriters will be given a short period of time in which to bid a price at which they are willing to purchase the issuer's securities. A bidder in a bought deal will not have had an opportunity to conduct any marketing effort before it provides the bid price and agrees to enter into a firm commitment to purchase the securities from the issuer. The securities will be issued in a registered public offering and may be offered by the issuer (primary shares) and/or selling stockholder(s) (often affiliate(s)) of the issuer (secondary shares). The bought deal process will be substantially the same in either case.

Given that the underwriters must agree to a price in advance of conducting any marketing, a bought deal entails significant principal risk. As a result, underwriters in bought deals will negotiate a significant discount, to offset the risk when purchasing the securities from the issuer or selling stockholder(s). Underwriters also may form a syndicate for a bought deal so that each firm bears only a portion of the risk.

***What happens if the underwriters do not sell the securities?***

If the underwriters cannot sell the securities, they must hold them and sell them over time. This is usually the result of the market price of the securities falling below their public offering price, resulting in the underwriters losing money. Furthermore, having to hold the securities will often also use up a portion or all of the underwriters' available regulatory capital, which could probably otherwise be put to better use, as most underwriters are not typically in the business of purchasing new issues of securities.

If an underwriter does not sell the securities and holds them in a proprietary account, it will not be limited to the passive market making allowed under Section 103 of Regulation M. However, it may be subject to further prospectus delivery requirements along with potential liability under Section 11 of the Securities Act of 1933, as amended (the "Securities Act"), upon the resale of such securities.

***Why would an issuer choose to pursue a bought deal over a typical underwritten offering?***

An issuer may choose a bought deal because it can be accomplished quickly. The issuer does not publicly announce its intention to offer securities until it receives a definitive commitment from the underwriters to purchase the securities. As a result, in a bought deal, there is little possibility for investor front-running and, as a result, an issuer may believe that it will obtain better pricing. An issuer may prefer a bought deal over a confidentially marketed public offering because it may not be inclined to bear price risk and may need certainty of execution. However, the issuer typically will be asked to accept a significant discount to the prevailing closing price of its securities in a bought deal, and bought deals generally are only feasible for issuers that are well-known seasoned issuers ("WKSIs"), as defined in Rule 405 under the Securities Act, with highly liquid stocks. Otherwise, underwriters likely will not feel comfortable quoting a fixed price.

Bidding underwriters may be somewhat aggressive in bidding, but, given the risks, the bidding underwriters will still bid at a discount to the prevailing market price for the stock in order to mitigate their execution risk.

***What does an issuer need to do in order to execute a bought deal?***

Generally, in order to execute a bought deal, an issuer must have an effective shelf registration statement. If the issuer does not have an effective shelf registration statement, it may still be able to execute a bought deal, provided that it is a WKSI, since a WKSI can file an immediately effective automatic shelf registration statement on Form S-3 without review by the Staff of the Securities and Exchange Commission (the "SEC"). Non-WKSI issuers without an effective shelf registration statement, by contrast, will not be in a position to consider a registered bought deal because they will not typically have the time to wait for a new Form S-3 registration statement to become effective. However, an unregistered Rule 144A-type offering might be executed as a bought deal, although this option usually will be considered only by foreign (non-U.S.) issuers. For more information, *see* our Frequently Asked Questions About Shelf Offerings, available at:

[http://www.mofo.com/files/Uploads/Images/FAQShelfOfferings.pdf](http://www.mofo.com/files/Uploads/Images/FAQShelfOfferings.pdf).

Next, the issuer must ensure that it has sufficient capacity under its shelf registration statement to execute the bought deal. Again, qualifying as a WKSI here will prove convenient as a WKSI does not need to specify an aggregate dollar amount or number of securities when filing a shelf registration statement, as a WKSI can rely on the "pay-as-you-go" provisions of Rules 456(b) and 457(r) under the Securities Act to pay fees at the time the final prospectus supplement for the offering is filed under Rule 424(b) under the Securities Act. Even if the WKSI shelf registration statement specifies a maximum deal size and there is insufficient remaining capacity, a WKSI can simply file a new, immediately effective automatic shelf registration statement. An issuer that is not a WKSI but is still Form S-3 eligible can upsize its existing shelf registration statement if there is insufficient capacity using the immediately effective short-form registration statement pursuant to Rule 462(b) under the Securities Act. However, this option can only be used once per shelf registration statement and also is limited to 20% of the unused capacity of the original shelf registration statement.

An issuer should prepare, with the assistance of counsel, a prospectus supplement (to the base prospectus included in the shelf registration statement) that can be shared with bidding underwriters. Counsel will work with the issuer to ensure that the issuer's public disclosures are current and that no updating of risk factors or other information is necessary in connection with the proposed offering. The issuer also will need to contact its auditors in advance so that the auditors are well aware of the issuer's plans and can be in a position to deliver a comfort letter to the underwriters at pricing. Execution will be simplified if the issuer has designated underwriters' counsel. Designated underwriters' counsel may be contacted in advance by the issuer and its counsel in advance of any contact being made with the potential underwriters so that designated underwriters' counsel can update its due diligence and work with the issuer and its counsel on the underwriting agreement, the prospectus supplement and the comfort letter.

***Can a bought deal be executed if no registration statement is available?***

While most bought deals are conducted on a registered basis using an effective shelf registration statement, it is possible for U.S. issuers to execute a bought deal on an exempt basis when an effective registration statement is not available. The mechanics of the bought deal will generally remain the same. Due to the nature of the exempt offering, the universe of available purchasers for an exempt bought deal will be limited to accredited investors (for Regulation D private placements), qualified institutional buyers (for Rule 144A offerings), and "non-U.S. persons" (for Regulation S offerings). Furthermore, as with any other unregistered offering, the securities will be "restricted securities" subject to restrictions on transfers and resales. This may force the issuer to provide a bigger discount due to the lack of liquidity.

***Are there times when it is easier to execute a bought deal?***

Generally, it is easier to undertake a bought deal immediately or shortly after an issuer's earnings announcement and the filing of its latest quarterly report on Form 10-Q or annual report on Form 10-K in order to coincide with a trading window in the issuer's insider trading policy (in the case of a secondary trade), and to avoid the need to update disclosure prior to launch, as the issuer's disclosures will be current. Waiting until the issuer's earnings announcements and the filing of the Forms 10-K or 10-Q will also make it easier for the underwriters to conduct due diligence and for the underwriters to obtain a comfort letter from the issuer's auditors.

***Can a bought deal be executed for secondary shares?***

Yes, a bought deal may be executed for secondary shares. A selling stockholder with a substantial position may choose to liquidate its position through a bought deal in order to quickly sell, mitigate its risk and obtain a set price. Also, a significant stockholder, such as a financial or private equity sponsor, may want to dispense with its position through an underwritten offering as the other liquidity alternatives may not be completed as quickly and may provide less certainty. If a bought deal for secondary shares is conducted on a registered basis, the shelf registration statement must generally allow for sales by selling stockholders and specific disclosure regarding the selling stockholders can be included in a prospectus supplement.

## Documentation for Bought Deals

***What is included in an issuer's bid package?***

When contacting potential underwriters to solicit bids for a bought deal, an issuer will provide a bid letter specifying the terms of the transaction and specifying the deadline for bid submissions. An issuer also will provide:

- a copy of the proposed underwriting agreement;
- a draft of the comfort letter from the issuer's auditors (or assurance that a comfort letter in the customary form will be provided); and
- a draft of the prospectus supplement.

The bid package may also include a current investor presentation, as well as a "launch" press release. Along with the bid package, the issuer should reassure the bidding underwriters that it is not providing or sharing any material non-public information with the underwriters (other than the fact that the issuer may undertake a bought deal).

***What documents are used to execute a bought deal?***

The documentation for a bought deal is very similar to that used in any underwritten offering. The issuer and/or the selling stockholder(s), as applicable, will enter into an underwriting agreement with the underwriters. As discussed above, due to the accelerated timing of a bought deal, the issuer must have an effective shelf registration statement. The issuer and its counsel will prepare a preliminary prospectus supplement and a launch press release. After launch, the press release will be filed or furnished on Form 8-K. After the transaction prices, the final prospectus supplement will be filed as well, and the underwriting agreement will be filed as an exhibit to a Form 8-K.

In connection with the offering, the underwriters will receive a standard comfort letter from the issuer's auditors, standard legal opinions from issuer's (and, if applicable, selling stockholders') counsel, and a 10b-5 negative assurance letter from issuer's counsel and from underwriters' counsel. If the selling stockholders are affiliates, they will often provide to the underwriters a representation letter to the effect that the selling stockholders are not in possession of any material non-public information that they are using to make their decision to execute the bought deal.

In a variable price re-offer transaction, there are a few specialized changes to the documentation that underwriters should keep in mind. First, the cover page of the preliminary prospectus supplement will not be set up to disclose the gross proceeds of the offering, minus the underwriters' discounts and commissions. The table that is included in the prospectus supplement for a typical underwritten offering to show these amounts both on an aggregate and per-share basis is omitted. Instead, the issuer generally discloses (1) the per share price due to it from the underwriters, and (2) the fact that the underwriters will re-offer the securities to the market at a range of varying prices. A longer explanation of variable price re-offer also is included in the underwriting section of the prospectus supplement.

If the underwriters convey final pricing terms in writing when they confirm final orders (through what is often referred to as a "Rule 134 release"), then that release should also disclose the variable price nature of the transaction and the highest clearing price to the market. The transaction will typically close like most transactions, on a T+3 or T+4 basis.

## Due Diligence for Bought Deals

***How is due diligence conducted in a bought deal?***

A bought deal is subject to the same disclosure and liability concerns as any traditional underwritten offering. Therefore, despite the time pressure imposed on the offering process, the issuer and the underwriters will need to ensure the accuracy and completeness of the disclosure prior to pricing the offering.

Generally, underwriters will only participate in bought deals for issuers with which they are (as an institution) quite familiar. The underwriters may provide research coverage on the issuer, may have participated in prior offerings by the issuer, or may have conducted non-deal road shows for the issuer. This familiarity will be essential in order for the underwriters to participate in the process and complete their due diligence quickly and efficiently.

As soon as an underwriter becomes aware of the potential offering and decides to submit a bid to the issuer, then that underwriter should commence its due diligence. The issuer will make its management available for a standard business due diligence call, and the auditors make themselves available for an auditors' due diligence call. Designated underwriters' counsel will have conducted periodic legal due diligence or may be in the midst of conducting their legal due diligence. Underwriters' counsel generally will undertake standard "shelf" or periodic due diligence, which typically consists of reviewing the issuer's public filings, reviewing exhibits to the public filings, reviewing press releases, determining whether there have been any changes to the issuer's ratings, conducting a due diligence call covering regulatory and litigation matters with the issuer or its counsel, and reviewing minutes and other corporate documents.

***What materials should a bidding underwriter review?***

A bidding underwriter should review carefully all of the materials in the bid package, and should consult with either designated underwriters' counsel or, if counsel is not designated, issuer's counsel, to verify that the underwriting agreement is in customary form, that there are no exceptions or qualifications in the comfort letter, and that issuer's counsel and designated underwriter's counsel both will provide standard legal opinions and 10b-5 negative assurance letters. The bidding underwriter will also want to confirm that the issuer's public disclosures are current.

## Marketing for Bought Deals

***Do bought deals entail any marketing before launch?***

It depends. In the conventional bought deal, the issuer will set out the bid process, the bidders will submit their information, business and accounting due diligence calls will take place, and the winning underwriters will be chosen. Promptly thereafter, the issuer and the underwriters will sign the underwriting agreement.

Sometimes, the underwriters may conclude that better execution requires some measure of pre-marketing. In this case, the issuer and the underwriters will agree that the underwriters can conduct limited pre-marketing to investors that have been "wall-crossed." There are various ways in which the underwriters can gauge the market to determine whether certain investors will participate in the offering. If the underwriters do not wish to restrict investors with whom they speak, they can take a no-names approach, and just talk to investors about securities of an issuer in a particular industry or sector having a certain market capitalization. There will be no specific references made to the issuer of the specific deal the underwriters have bought or intend to buy.

If the underwriters wish to obtain a more concrete indication of interest from investors about the particular bought deal, the underwriters will have to "wall-cross" the investor. If the investor agrees to be taken "over the wall," the underwriters will send the investor an email confirming its willingness to keep any information conveyed strictly confidential and the investor will be required to send a return email acknowledging the confidentiality agreement. In some cases, formal confidentially agreements or non-disclosure agreements may be signed for the benefit of the issuer and the underwriters.

The length of this pre-marketing period may vary. Once the issuer has chosen the underwriters, it may agree that the underwriters may reach out to investors for a few hours prior to the issuance of the launch press release. The underwriters should follow their typical approach for wall-crossing investors.

***How is a bought deal launched?***

A bought deal usually will be announced promptly after market close through the issuance of a launch press release. The launch press release is intended to comply with Rule 134 under the Securities Act. Rule 134 enables an issuer with an effective registration statement to issue a press release that includes certain limited information related to an offering without the communication being deemed to be a prospectus or an issuer free writing prospectus. This Rule 134 release also simultaneously satisfies the requirements of Regulation FD, which requires an issuer to publicly disclose any material, non-public information simultaneously with its intentional disclosure to the financial community at large. A bought deal may or may not on its own constitute a material development. An issuer would be wise to satisfy Regulation FD with a press release, particularly one concurrently filed on a current report on Form 8-K, rather than assume that the bought deal is not material.

Sometimes an issuer will use an issuer free writing prospectus under Rule 433 under the Securities Act to launch a bought deal, though this is less common. The issuer should ensure that whatever approach taken properly conveys all of the information required to be disclosed to investors under the federal securities laws.

The issuer and the underwriters may agree to use a preliminary prospectus supplement (to the base prospectus included in the shelf registration statement). A preliminary prospectus supplement is not required, but it may be useful in order to convey recent developments or provide new or additional information about the issuer. The preliminary prospectus supplement will not contain pricing information; however, it may state whether the offering is structured as a fixed-price deal or a variable re-offer deal. The preliminary prospectus supplement must be filed within 48 hours of first use.

After the launch of the transaction, it remains critical to maintain the confidentiality of the price the underwriters have agreed to pay the issuer and/or selling stockholder(s) for the securities. If an investor obtains this price information, the investor might attempt to extract better pricing from the underwriting syndicate, which may affect deal execution. For this reason, the price paid by the underwriters should not appear in any press release at launch or in the preliminary prospectus supplement.

## Pricing for Bought Deals

***What is a fixed-price offering?***

When filing its shelf registration statement, it is impossible for an issuer to know the exact method of distribution that will be used by underwriters in future takedowns. Therefore, the issuer should include broad language in the base prospectus (included in the shelf registration statement) so that at the time of a takedown there will be no need to update this information. Issuers typically use the following language for this purpose:

> We may sell the securities covered by this prospectus in any of three ways (or in any combination): (1) to or through underwriters or dealers; (2) directly to one or more purchasers; or (3) through agents.
>
> We may distribute the securities covered by this prospectus from time to time in one or more transactions: (1) at a fixed price or prices, which may be changed from time to time; (2) at market prices prevailing at the time of sale; (3) at prices related to the prevailing market prices; or (4) at negotiated prices.

In a fixed-price offering, the underwriters purchase the shares from the issuer and re-offer the securities to the public at one fixed price, also referred to as a "clearing price." While the underwriters expect to sell the entire offering at the fixed-price, the plan of distribution for the offering will often contain language allowing the underwriters to change the pricing at any time without notice, in case the underwriters find themselves with securities they cannot sell at the clearing price. This situation, where the underwriters expect to encounter difficulties selling all of the securities, is often referred to as a "sticky deal."

***What is a variable price re-offer?***

In a variable price re-offer, the issuer discloses that the underwriters may vary the price at which the securities are offered to the public and sell the securities, from time to time, in various types of transactions. In a variable price re-offer, there is no announcement at pricing of a single price paid to the issuer because the underwriters may still be "long" the securities at that point.

The underwriters may vary the price at which they offer the securities, take the securities into a proprietary account (unlikely), or place them in managed accounts. Because of the proprietary risk taken by the underwriters, these transactions present significant deal and pricing risk for underwriters. Pre-announcement, it is important that precautionary measures are taken to prevent information leaks that can lead to shorting activity and harm the transaction. Participants should be advised and reminded of their obligations to keep matters confidential.

***Are there any restrictions on the issuer once the bought deal is launched?***

Typically, in order to assist the underwriters in distributing the securities they purchased in the bought deal, the issuer, along with certain company insiders and any selling stockholder(s), will agree not to sell any of the issuer's securities for a certain period of time after the offering, usually ranging from 30 to 90 days.

***When is pricing information for a bought deal disclosed to the public?***

After the end of the overnight (or otherwise agreed-upon) marketing period, underwriters often will express confidence that they have allocated the entire block of securities to investors (or close to it), in which case the issuer will be eager to announce the "pricing" of the transaction. However, announcement of pricing should not be made until investor orders have been confirmed (after which the underwriters' risk is greatly reduced).

***How is pricing information shared with the public?***

Issuers are not specifically required by rule to publicly announce the results of an offering prior to filing the final prospectus supplement. However, there may be Regulation FD concerns if the clearing price is known only to a limited number of market participants. Including the clearing price in a pricing press release will address any Regulation FD concerns.

Furthermore, the New York Stock Exchange (the "NYSE") requires a pricing press release if certain of the pricing terms are considered to be material information.[1] Therefore, an issuer should issue a pricing press release to ensure that the NYSE does not raise issues after the fact.

Underwriters often will want to withhold pricing information as long as possible, particularly if they have not yet sold their entire position. If an issuer presses to disclose the proceeds of the offering, a compromise may be reached by including in a pricing press release the amount of gross proceeds before deducting underwriting discounts and commissions and offering expenses. This amount would be calculated based on the closing trading price on the launch date and the number of shares sold, but would not inform the market of the price paid by the underwriters.

Counsel generally will take the view that the underwriting discounts and commissions and the fixed price are not in and of themselves material, and that the issuer has shared with the market all of the information that may be deemed material (*e.g.*, the size of the deal,

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[1] Section 202.05 of the NYSE's Listed Company Manual states:

> "A listed company is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities. This is one of the most important and fundamental purposes of the listing agreement which the company enters into with the Exchange."

However, the NYSE usually leaves the ultimate determination of materiality with the company itself.

certainty regarding the deal, timing of the deal, and, possibly, gross proceeds).

***When will the final prospectus supplement be filed?***

While in a typical underwritten offering, the final prospectus supplement is filed within a day of pricing, in a bought deal, the filing of the final prospectus supplement usually is delayed as long as possible. The final prospectus supplement must be filed within two business days of first use, in which case the deal team will have 48 hours during which the market may still be unaware of the pricing details.

In the case of a variable price re-offer, the final prospectus supplement also will contain the amount paid by the underwriters, and filing also may be delayed (in this case, it should be filed within two business days of the pricing of the offering, but not before).

## Block Trades

***What is a block trade?***

A block trade is defined as an order or trade submitted for sale or purchase of a large quantity of securities: generally 10,000 shares or more (not including penny stocks) or a total market value of $200,000 or more in bonds. The shares "traded" may be restricted securities or control shares, or may be sold off of an effective shelf registration statement. Certain types of block trades need to be reported to the Financial Industry Regulatory Authority, Inc. ("FINRA") and the securities exchanges. For more information, *see* our Frequently Asked Questions About Block Trade Reporting Requirements.

***Who is likely to pursue a block trade?***

An issuer may sell its securities through a block trade; however, that is an unlikely and uncommon scenario. Institutional investors, including mutual funds and pension funds, often execute block trades, while individual investors usually do not. Block trades also are typically used by financial or private equity sponsors, venture capitalists, and other large stockholders who may have acquired large quantities of securities in an M&A or other transaction and wish to sell down their position.

An investment bank may execute a block trade on an agency or best efforts basis, or on a principal basis. Often an affiliate of the issuer may choose to sell securities through a block trade as it may not be able to meet the requirements of Rule 144 under the Securities Act ("Rule 144") for the public resale of its securities (*e.g.*, one-year holding period, volume limitation, etc.). Unlike Rule 144, there is no volume limitation or prohibition on soliciting buyers applicable to a block trade, making it an enticing option for an affiliate that cannot use Rule 144 for resales.

***Why would one pursue a block trade?***

A block trade offers certain advantages to the selling stockholder. Many securities exchanges permit large block trades to be privately negotiated and transacted off-exchange. Upon being reported to the relevant exchange, the transaction becomes centrally cleared, and the parties to the transaction no longer have to worry about other parties affecting the trade. A block trade also allows a party with a desire to engage in a large-sized transaction to access a different and often larger investor base than regular electronic trading. In addition, block trades are often cheaper than standard underwritten transactions, and are fast and effective for smaller amounts of stock than are typically offered in an underwritten transaction.

## "Distributions" for Block Trade Purposes

***Are block trades considered to be "distributions" under the securities laws?***

Block trades that are considered "distributions" under the securities laws must be reported under the trade reporting rules of FINRA and could subject the broker-dealer executing the trade to liability as a statutory underwriter under the Securities Act.

Section 2(a)(11) of the Securities Act defines an underwriter as "any person who offers or sells for an issuer in connection with the distribution of any security." For purposes of this definition, the SEC has defined "issuer" broadly to include any person directly or indirectly controlling or controlled by the issuer or under common control with the issuer. As a result, activities undertaken by a broker-dealer on behalf of affiliates of an issuer (*e.g.*, officers, directors and 5% stockholders) may raise the same concerns as those taken on behalf of the issuer. Furthermore, one does not need to be engaged formally as an underwriter or placement agent in order to incur this potential liability. The broker-dealer's relationship to the transaction, the extent of its activities and its fees determine whether it may be considered to be acting as a statutory underwriter.

While this broad definition of an "underwriter" is fact-specific, the SEC has routinely refused to make determinations on specific cases, explaining that the individual or entity in question is in a better position than the SEC to determine its status. In addition, the SEC has not included definitions in the Securities Act for certain of the other terms used in Section 2(a)(11), particularly, the term "distribution." It is clear that only when a "distribution" occurs can an underwriter be involved.

Generally, the marketing and related activities surrounding a block trade may not rise to the level generally associated with a "distribution" under the federal securities laws. The shares purchased and sold often are placed quickly for a standard dealers' fee, without the use of sales documents and with little sales effort by the broker-dealer. Further, these shares also often are sold to relatively few institutional buyers who already may have expressed an interest in obtaining stock. However, under certain circumstances, block trades may be considered a "distribution," which has the effect of exposing the broker-dealer to potential liability as an underwriter.

The nature of the party for whom the broker-dealer is executing the block trade may affect whether the transaction is deemed a "distribution" of securities for an issuer. A "distribution" may include a private transaction as well as a public (pursuant to a registration statement) transaction. As used in the Securities Act, an "issuer" is defined to include the issuer itself and its affiliates or control persons. In executing a block trade on behalf of an issuer or on behalf of an affiliate, a broker-dealer should consider the factors discussed below and may wish to structure its activities in a manner intended not to constitute a "distribution." However, if a broker-dealer is executing a block trade on behalf of a third party (unrelated to the issuer and not an affiliate or control person), depending on the facts and circumstances, it may be more likely than not that the transaction is not deemed to constitute a "distribution."

***Does Regulation M provide any helpful guidance?***

Regulation M, adopted by the SEC to curtail manipulative practices by distribution participants, provides some guidance for determining whether a "distribution" exists. This guidance helps narrow the broad scope of the definition of an underwriter by limiting the situations in which that definition is implicated.

Regulation M defines a "distribution" as "an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods." This definition sets forth two criteria to consider in determining whether activities give rise to a distribution: (1) the magnitude of the offering and (2) whether special selling efforts and selling methods are used in connection with the offering. Presumably, if these factors are absent, the transaction would be considered an ordinary trading transaction and not a "distribution."

***How does the magnitude of an offering help determine whether a "distribution" exists?***

In determining the magnitude of an offering, the SEC looks to:

- the number of shares being registered or sold;
- the percentage that these shares represent of the total outstanding shares of that issuer;
- the issuer's public float; and
- the average trading volume of the issuer's securities.

All of these factors must be taken in context and it is important to note that what may be a problematic fact pattern for one issuer may not raise concerns with respect to another issuer.

***What are "special selling efforts" that a trading desk may use in executing block trades?***

Activities that may constitute special selling efforts and selling methods might include a broker-dealer receiving higher compensation than it ordinarily would receive for normal trading transactions (or dealer activity), the use by such broker-dealer of sales documents, conducting a road show in connection with the transaction, or holding investor meetings. Presumably, if these factors are absent, the transaction would be considered an ordinary trading transaction and not a "distribution."

The definition of a "distribution," because it is based on facts and circumstances, can lead to the same facts being considered a "distribution" in one case but not in another. Certain activities may constitute special selling efforts or methods for one broker-dealer while for another larger, established broker-dealer with an active block trading desk, such activities may be in keeping with its regular trading activities. For this reason, a broker-dealer must analyze each situation not only on its merits, but also in the context of the broker-dealer's regular activities.

## Documentation and Marketing for Block Trades

***What documentation is required for the execution of a block trade?***

Not all block trades will require the same documentation. In cases where the broker-dealer is executing the block trade on an agency or best efforts basis, it may want a sales agency agreement or, in certain cases, an underwriting agreement. This is less common in cases where the broker-dealer is executing the block trade on a principal basis. The underwriting or sales agency agreement will contain certain stripped-down representations from the seller (including as to valid title, no encumbrances and compliance with securities laws). The underwriting or sales agency agreement also will contain pricing and settlement provisions and will likely contain an indemnity from the seller to the broker-dealer.

If the block trade is considered a "distribution" for purposes of the federal securities laws, then the broker-dealer will want to have a due diligence defense available to it to mitigate its potential liability as an underwriter. If that is the case, then the broker-dealer will need time to review the issuer's public disclosures and may ask the issuer to provide it with other materials it wishes to review.

Sometimes law firms will be asked to provide legal opinions, usually covering the seller's corporate authority, authority to sell the securities and valid title to the securities. A broker-dealer also may request a no-registration opinion, confirming that the block trade does not need to be registered with the SEC. In addition, investors in the block trade may be asked to sign representation letters acknowledging, among other things, the absence of offering documents, their financial sophistication and any selling restrictions applicable to the securities.

If the broker-dealer engages in marketing efforts for the block trade, then it may become necessary for the issuer to issue a press release to satisfy Regulation FD requirements if the trade is considered material, or if some market participants have been provided information that others may not have.

***Is there any marketing period for a block trade?***

No. Generally there is no marketing for block trades, as these trades are not usually considered "distributions" and are not typically underwritten deals. Furthermore, there is no traditional "road show" for a block trade and any selling efforts would be targeted directly at a few institutional investors. However, the disclosure obligations for sales made through block trades are just as rigorous as they would be in any typical underwritten offering and the potential for liability exists in block trades as well.

## Block Trades and the Section 4(a)(1½) Exemption

***What is the Section 4(a)(1½) exemption?***

The Section 4(a)(1½) exemption provides a specific exemption for the private resale of restricted or control securities, and can be used to execute block trades. The Section 4(a)(1½) exemption is useful for and popular with investors because it permits the private sale of restricted or control securities without having to rely on the exemption from registration provided under Rule 144. Under Rule 144, a non-affiliate investor would have to satisfy a six-month holding period and an affiliate investor would have to satisfy a one-year holding period and would be subject to certain volume limitations and manner of sale requirements. However, the Section 4(a)(1½) exemption does not impose such holding period requirements, volume limitations or manner of sale requirements.

The Section 4(a)(1½) exemption is a hybrid exemption consisting of:

- the exemption under Section 4(a)(1) of the Securities Act ("Section 4(a)(1)"), which exempts transactions by anyone other than an "issuer, underwriter, or dealer," and
- the analysis under Section 4(a)(2) of the Securities Act ("Section 4(a)(2)") to determine whether the seller is an "underwriter" (in other words, whether the seller purchased the securities with a view towards a "distribution").

Note that the exemption from registration under Section 4(a)(1) is not available because it applies solely to open market or public transactions by individual security holders who hold neither restricted securities or control securities. The exemption from registration under Section 4(a)(2) is not available because it only applies to transactions by an issuer not involving a public offering (and not a selling stockholder).

In 1980, the SEC recognized the Section 4(a)(1½) exemption, which, although not specifically provided for in the Securities Act, clearly was within the intended purpose of the Securities Act, provided that the established criteria for sales under both Section 4(a)(1) and Section 4(a)(2) are satisfied.[2] However, the SEC has since declined to provide further guidance through no-action letter relief.

***What types of investors can use the Section 4(a)(1½) exemption?***

Section 4(a)(1½) offerings can be used by a variety of investors. The Section 4(a)(1½) exemption can be used by institutional investors (typically sponsors, venture capitalists and other large securityholders, who acquired their securities in connection with M&A transactions) to resell their restricted securities or control securities. The Section 4(a)(1½) exemption also can be used by affiliates to sell control securities when the exemption under Rule 144 is not available. In addition, the Section 4(a)(1½) exemption can be used for resales to accredited investors.

***How are sales utilizing the Section 4(a)(1½) exemption structured?***

In a Section 4(a)(1½) transaction (1) the seller must sell in a "private" offering to an investor that satisfies the qualifications of an investor in a Section 4(a)(2) private offering,[3] and (2) the investor must agree to be subject to the same restrictions imposed on the seller in relation to the securities (for example, receiving securities with a restricted legend), in order to demonstrate that the seller is not making the sale with a view towards distribution. However, the investor would still be able to "tack" the holding period of the seller for purposes of satisfying the holding period requirement under Rule 144, if the investor chooses to use the exemption from registration under Rule 144 for a subsequent sale of the securities.

If a purchaser buys securities in a private placement with the intent to resell the securities or serve as a conduit from the issuer to other buyers, Section 4(a)(2) would be violated, and the purchaser will be deemed to have acted as an underwriter. If this occurs, the offering

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[2] *See* Employee Benefit Plans, Securities Act Release No. 6188, 19 SEC Docket 465, 496 n.178 (Feb. 1, 1980) (acknowledging the existence of the Section 4(a)(1-1/2) exemption), available at: http://www.sec.gov/rules/interp/33-6188.pdf.

[3] An investor in a Section 4(a)(2) offering must meet the qualifications laid out by the U.S. Supreme Court in *SEC v. Ralston Purina*, 346 U.S. 119 (1953). Under *Ralston Purina*, purchasers must (1) be sophisticated and (2) have access to the same information as would be available if the securities were registered.

may be deemed a public offering. Deeming the offering to be public would require the issuer to register the offering of the securities with the SEC and each and every state into which it sold its securities.

Section 4(a)(1½) offerings are often structured in the form of a block trade, where the seller engages a financial intermediary to help sell the securities as agent. Because the Section 4(a)(1½) exemption seeks to recreate the conditions that enabled the original private placement, a number of common practices have emerged among practitioners in connection with Section 4(a)(1½) transactions, similar to those typically applicable to Section 4(a)(2) or Regulation D private placements, including:

- the purchaser agreeing to resale restrictions and making representations and warranties regarding its sophistication and investment intent;
- inquiring into the identity of the purchaser, including its financial condition, in order to assess the likelihood that the purchaser will be able to hold the securities for investment and not resell prematurely;
- requiring legal opinions confirming the view that no registration is required for the offering;
- including restrictive legends on the securities to alert the purchaser to the restricted nature of the securities;[4]
- requiring stop transfer instructions from the issuer;[5] and
- using a large minimum investment to bolster the purchaser's claims regarding its sophistication and investment intent.

These common practices are typically memorialized in provisions contained in a securities purchase agreement entered into between the seller and the purchaser or, if the Section 4(a)(1½) transaction is structured in the form of a block trade, a sales agency agreement (if the financial intermediary is acting as agent). In the case of a block trade, the financial intermediary also may want to conduct due diligence on the issuer and have the issuer issue a press release regarding the completion of the offering.

## Block Trades and the Section 4(a)(7) Exemption

***What is the Section 4(a)(7) resale exemption?***

Section 76001 of the Fixing America's Surface Transportation Act ("FAST Act"), signed into law on December 4, 2015, incorporates the provisions of the Reforming Access for Investments in Startup Enterprises Act that codify a new Section 4(a)(7) under the Securities Act ("Section 4(a)(7)"). Section 4(a)(7) became effective immediately after the FAST Act was signed into law.

Section 4(a)(7) provides an exemption (the "Section 4(a)(7) resale exemption") for certain accredited investor transactions involving unregistered resales and partially resembles the Section 4(a)(1½) exemption for private resales of restricted securities although it is more limited in scope (*see "How does the Section 4(a)(7) resale*

[4] If the seller is an affiliate, the legend should clearly indicate that the securities are restricted securities within the meaning of Rule 144(a)(3) under the Securities Act and cannot be resold publicly under Rule 144 until the purchaser meets the holding period requirement of Rule 144(d), which restarts upon the acquisition of the securities from an affiliate.

[5] The seller will often arrange to have the issuer issue a stop transfer order to the transfer agent for the restricted securities to prevent the purchaser from reselling the securities purchased in the Section 4(a)(1½) offering without obtaining a legal opinion with respect to the legality of the resale.

*exemption differ from the Section 4(a)(1½) exemption?"*). The Section 4(a)(7) resale exemption is a non-exclusive safe harbor, so Section 4(a)(1½) remains available.

***What are the requirements of the Section 4(a)(7) resale exemption?***

Section 4(a)(7) exempts resale transactions that satisfy the following requirements:

- each purchaser is an accredited investor;
- neither the seller nor any person acting on the seller's behalf engages in any form of general solicitation; and
- in the case of a non-reporting issuer that is neither (1)(a) exempt from reporting requirements pursuant to Rule 12g3-2(b) under the Exchange Act ("Rule 12g3-2(b)) nor (b) a foreign government eligible to register securities on Schedule B, then (2) at the seller's request, the seller and a prospective purchaser must obtain from the issuer reasonably current information, including:
  - the issuer's exact name (as well as the name of any predecessor);
  - the address of the issuer's principal place of business;
  - the exact title and class of the offered security, including its part or stated value;
  - the current capitalization of the issuer;
  - details for the transfer agent or other person responsible for stock transfers;
  - a statement of the nature of the issuer's business that will be presumed current if it is as of 12 months before the transaction date;
  - information about any broker, dealer or other person being paid a commission or fee in connection with the sale of the securities;
  - the issuer's most recent balance sheet and profit and loss statement and similar financial statement, prepared in accordance with U.S. Generally Accepted Accounting Principles ("GAAP") or, in the case of a foreign issuer, the International Financial Reporting Standards ("IFRS"), for the two preceding fiscal years during which the issuer has been in business; and
  - if the seller is an affiliate, a statement regarding the nature of the affiliation accompanied by a certification from the seller that it has no reasonable grounds to believe that the issuer is in violation of the U.S. securities laws or regulations.

***When is the Section 4(a)(7) resale exemption not available?***

The Section 4(a)(7) resale exemption is not available if: (1) the seller is a direct or indirect subsidiary of the issuer; (2) the seller or any person that will be compensated in connection with the transaction is disqualified as a bad actor pursuant to Rule 506(d)(1) of Regulation D or disqualified pursuant to Section 3(a)(39) of the Exchange Act; (3) the issuer is a blank check, blind pool or shell company, special purpose acquisition company, or in bankruptcy or receivership; (4) the transaction relates to a broker-dealer's or underwriter's unsold allotment; or (5) the security that is the subject of the transaction is part of a class of securities that has not been authorized and outstanding for at least 90 days prior to the transaction date.

***Are securities sold in a Section 4(a)(7) resale transaction "restricted securities"?***

In contrast to securities sold pursuant to Rule 144, securities sold pursuant to the Section 4(a)(7) resale exemption are "restricted securities" under the Securities Act and, therefore, subject to transfer restrictions. A transaction effected pursuant to the Section 4(a)(7) resale exemption will not be deemed to be a "distribution" under the Securities Act.

***Are securities sold in a Section 4(a)(7) resale transaction subject to state "blue sky" laws?***

The securities sold in a Section 4(a)(7) resale transaction are "covered securities" under Section 18(b) of the Securities Act and, therefore, exempt from state blue sky laws.

***How does the Section 4(a)(7) resale exemption differ from the Section 4(a)(1½) exemption?***

Under the Section 4(a)(7) resale exemption, the seller must provide any prospective purchaser with a substantial amount of information on any non-reporting issuer that is neither (1) able to rely on the exemption under Rule 12g3-2(b) nor (2) a foreign government eligible to register securities on Schedule B (*see "What are the requirements of the Section 4(a)(7) resale exemption?"*). Moreover, unlike the Section 4(a)(1½) exemption, resale transactions conducted pursuant to the Section 4(a)(7) resale exemption are subject to bad actor disqualifications (*see "When is the Section 4(a)(7) resale exemption not available?"*).

***How would a Section 4(a)(7) resale transaction likely be documented?***

As in a resale transaction conducted pursuant to the Section 4(a)(1½) exemption, the terms of a Section 4(a)(7) resale transaction would typically be memorialized in a securities purchase agreement between a seller and a purchaser. The securities purchase agreement would also contain representations and covenants establishing, among other things, that: (i) all purchasers are accredited investors; (ii) neither the seller nor any person acting on the seller's behalf engages in any form of general solicitation; and (iii) neither the seller nor any person that will be compensated in connection with the transaction is disqualified as a bad actor pursuant to Regulation D or the Exchange Act (for additional information that would likely be covered by a representation and/or covenant in the securities purchase agreement, *see "When is the Section 4(a)(7) exemption not available?"*).

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