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PRACTICAL ADVICE FOR THE CAPITAL MARKETS

Not So Black and White: Executing Capital Markets Transactions During Quarterly Blackout Periods

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Welcome to the inaugural edition of *Willkie CAPITAL LETTERS*, our new platform designed to provide *Practical Advice for the Capital Markets.*

In today's fast-evolving financial landscape, staying informed and ahead of the curve is critical. *Willkie CAPITAL LETTERS* is our commitment to delivering timely, actionable insights to our clients and stakeholders in the capital markets space. Through this platform, we aim to share our experience and perspectives to help you navigate the complexities of capital raising, securities regulation, and market dynamics with confidence.

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With the new year upon us, many companies are contemplating capital markets offerings. However, companies often voluntarily impose a "blackout" on capital markets transactions beginning near the end of a fiscal period and ending shortly after the public announcement of results for that fiscal period or the filing of the related annual, quarterly or special report. Companies impose these blackout periods to avoid issuing securities when there is a heightened risk that they may have, or be perceived to have, knowledge of the nearly or recently completed period's financial results or, in commonly used parlance, material non-public information (MNPI). Because it is difficult to predict in advance when financial information for a fiscal period will be available, many companies voluntarily impose blackout periods each quarter during which they don't issue securities and insiders are prohibited from transacting in company securities.

There are benefits to adhering to scheduled blackout periods, and companies are often well advised to wait until after they issue their earnings or file the related annual, quarterly or special report before accessing the capital markets. However, a self-imposed blackout period does not, as a matter of law, prevent a company from issuing securities so long as the company satisfies all disclosure obligations. There may be compelling reasons to issue securities during a blackout period, such as an immediate need for funds or a desire to take advantage of a limited market opportunity. In these or other circumstances, companies seeking to sell securities during a self-imposed blackout period may, under appropriate circumstances and after consultation with their underwriters and counsel, be able to still satisfy their disclosure obligations in connection with the offering.

This issue of *Willkie CAPITAL LETTERS* discusses factors to consider when contemplating a securities offering during a regularly scheduled blackout period. Different considerations are raised in connection with special blackout periods, such as those in connection with material corporate transactions, as well as those in connection with insider transactions in company securities, neither of which are discussed in this issue of *Willkie CAPITAL LETTERS*.[1]

Blackout Periods: What, Why and When

U.S. federal securities laws do not, per se, impose blackouts on the ability of a company to issue securities.[2] However, when a company possesses information about itself that a reasonable investor would consider important in making an investment decision, the company must disclose that information or refrain from selling its securities. Additionally, U.S. federal securities laws impose liability on companies that sell securities on the basis of untrue statements of material facts or the omission of material facts necessary to make the company's statements not misleading. Therefore, when a company discloses MNPI, it must ensure its statements are accurate.

While practices vary, regularly scheduled blackout periods generally begin shortly before, at or shortly after the end of a fiscal period and continue until shortly after the announcement of earnings for such fiscal period. The blackout period can be as short as a few weeks (*e.g.*, around the end of the first, second or third fiscal quarters) or as long as a few months around the end of the fiscal year. While companies typically plan their funding schedules well in advance taking into account their blackout periods, uncooperative market conditions or unscheduled needs (*e.g.*, M&A transactions) can cause companies to consider selling securities during a blackout period.

So Is a Blackout Period More Gray than Black?

Whether a company can (or should) issue securities during a blackout period involves a balance of considerations and a determination of the comfort level of various constituents participating in the transaction, including the company's

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1 Insider transactions in company securities can implicate actual or perceived "insider trading issues." To avoid potential regulatory investigations, third-party lawsuits, reputational issues and potential leaks of material information, companies typically impose quarterly blackouts on insiders, even where insiders are already subject to a pre-clearance requirement, or only allow insiders to trade during designated "open window" (*i.e.*, non-blackout) periods.

2 Rule 3-12(a) of Regulation S-X requires that a company's latest financial statements included or incorporated by reference in a registration statement be as of a date less than 135 days (or 130 days in some instances) before the date that the registration statement is expected to become effective. In practice, this only restricts a company proposing to publicly offer securities shortly after the end of its fiscal year because the Form 10-K, with updated financial statements, is not due until after the 135-day deadline. In the case of a company that (1) has filed all Exchange Act reports that were due; (2) expects to report net income (after taxes but before extraordinary items and the cumulative effect of any changes in accounting principles) in the year just completed; and (3) has reported such net income in at least one of the two previous years, the SEC staff provides a grace period taking reporting companies up to their Form 10-K due date. While not a technical blackout, this may limit the ability of certain companies that do not have an effective shelf registration to publicly offer securities shortly after their fiscal year-end.

management and board (most likely represented by the audit committee or the chairman of the audit committee), underwriters, various counsel and auditors, as well as an evaluation of a number of legal and non-legal considerations.

Constituents

Management and the Board – Management and the board must evaluate how critical the funding need is, whether there are other reasonable funding alternatives available and the legal and non-legal risks of proceeding or not proceeding. For a public offering, the company, the company's principal executive, financial and accounting officers, and those directors who sign the registration statement have potential liability for material misstatements in, or omissions from, the registration statement and prospectus. For an unregistered offering, potential liability still exists under Rule 10b-5 of the Securities Exchange Act of 1934, as amended (Exchange Act). Even if there is no legal liability, the company may still face reputational harm if its reported results after the issuance are not in line with market expectations.

Underwriters – The underwriters of the offering must also be comfortable moving forward because underwriters have potential liability for material misstatements in, or omissions from, the registration statement and prospectus as well as potential liability under Rule 10b-5. Reputational issues may be even more acute for underwriters because they interact with investors on a daily basis on behalf of numerous clients and will not want to risk harming those relationships over a single offering.

Counsel – In registered and many exempt offerings, counsel for the company and the underwriters typically provide so-called "negative assurance letters" stating that after conducting due diligence, nothing came to their attention that caused them to believe that there are any material misstatements in, or omissions from, the offering documents. While they may not face the same type or level of potential liability as the company, its management and board and the underwriters, counsel will not be willing to issue their "negative assurance letters" unless they are comfortable with the proposed disclosure (or lack thereof).

Auditors – In registered and many exempt offerings, the company's independent auditors will issue a comfort letter to the underwriters providing certain assurances with respect to financial information included in the offering documents. The comfort letter is crucial in helping the underwriters establish a statutory due diligence defense for potential liability. While comfort letters do not typically provide comfort regarding the absence of information, the company's auditors will not be willing to issue their comfort letter unless they are comfortable with the proposed disclosure (or lack thereof).[3]

Legal and Non-Legal Considerations

"Just the Facts Ma'am!" – While it might be a bit of a cliché (and thanks to the old TV series Dragnet), the facts matter. Although it may seem obvious, a company cannot disclose facts of which it is unaware. It is important to diligence the company's financial closing process, including when data will become available to management as well as any changes to that information that may occur through the closing of the offering, and the company's timeline for preparation of its financial statements, including any internal or external review processes. This may vary based on company-specific factors such as the type of business, industry and data aggregation processes. For example, a multinational conglomerate relying on various geographic and business segments to report into the parent company might experience a lag before a clear picture of the company's financial results are known, while other companies might track and have a sense of revenues and expenses on

[3] Just like Regulation S-X provides a 135-day limit on the age of financial statements included in a registration statement, Auditing Standard 6101 (Letters for Underwriters and Certain Other Requesting Parties) limits the negative assurance that auditors may provide in comfort letters after such 135th day.

a more timely basis. It is important for all transaction participants to understand the drivers of the company's financial performance in order to determine comfort with disclosure, as the absence of some key pieces of information may make incomplete information less helpful. It is also important to diligence whether significant changes have historically occurred during the closing process or the internal or external review process.

Not All Offerings Are Created Equal – When evaluating whether the absence of financial information for a recently completed fiscal period is material, context is crucial. Rule 10b-5 states that omissions are looked at "in the light of the circumstances under which they were made." Thus, the type of offering may impact the materiality analysis, with the same facts leading to different conclusions with respect to a debt offering versus an equity offering. In a debt offering, investors are primarily focused on the ability of the company to pay principal and interest on a timely basis and the consequent rating of the debt securities; thus small changes in the company's quarterly earnings may not be material to a reasonable investor. In the case of an equity offering, missing earnings expectations (whether in the form of guidance issued by the company or consensus estimates of securities analysts) might cause a significant drop in the company's stock price, resulting in disgruntled investors. Furthermore, an offering sold primarily to institutional investors may provide a different risk profile than an offering, whether debt or equity, primarily sold to retail investors.

If I Can't Wait, What Can I Do to Minimize the Risk?

If the company has concluded that it can't wait until its regularly scheduled earnings announcement and the offering participants have concluded that MNPI exists (or nonpublic information is close enough to "material" to cause concern), the company may choose to "pre-release" enough information to satisfy its disclosure obligations, often referred to as "flash numbers." Including flash numbers in an offering document is not a panacea and comes with its own risks and challenges. Two of the primary risks of disclosing "flash numbers" are that the final results may differ significantly from the pre-released numbers and the pre-released numbers may not be sufficient to inform investors about the material aspects of the company's financial condition. To minimize potential risks, offering participants should address the following:

What Can and Should Be Disclosed – The company should first determine what financial information is available, reliable and will be able to provide a balanced picture of the period's results. For example, if the company is aware of information indicating that revenue exceeds expectations but net income is lower than expected, it should not disclose revenue only. Attention also should be drawn to any financial data that the company knows may demonstrate a material deviation from existing trends. Both income statement and balance sheet items should be considered in this analysis. If the company wants to include any non-GAAP information, it should consider whether a meaningful reconciliation is possible in light of the various outstanding components.

Ask the Tough Questions – Similar to the diligence conducted in determining whether disclosure needs to be made, the offering constituents should perform diligence on the origin/derivation of the flash numbers, the procedures that remain to be completed by the company's internal accounting staff and/or independent auditors, and the company's history of revisions to its preliminary financial results as compared to final results.

Consider Using Ranges – Rather than disclosing specific numbers, which imply a level of accuracy, the company should consider disclosing ranges that provide a sense of the company's financial performance while also indicating that final figures are not yet available. The SEC Staff has stated that a range should represent a narrow, meaningful estimate. Ranges that are too broad risk being insufficient to satisfy the company's disclosure obligations.

Include Appropriate Qualifiers and Explanations – The disclosure should be clear that the information is preliminary and is based on then-available information. Appropriate disclosure should also be included stating that the company's financial closing procedures are not yet complete and, therefore the company's final results may vary from the information provided. It should also be made clear that the preliminary results were prepared by management and were not subject to audit, review or agreed-upon procedures of any audit firm, and therefore, there is no independent opinion or any other form of assurance with respect to those results. Finally, the company may need to include additional disclosure alongside the flash numbers explaining any differences from the prior comparative fiscal period.

Determine the "Art of the Possible" for the Comfort Letter – Underwriters expect that the financial information included or incorporated by reference in an offering document will be "comforted" by the company's auditors. However, auditors often categorically refuse to "tick-and-tie" flash numbers. A conversation with the auditors should be held to delve deeper into what procedures, if any, they can perform on the flash numbers. For example, figures taken from the general ledger, such as revenue, may be able to receive an "accounting records" tick-mark. Special consideration should also be given to offerings that occur after a fiscal year-end but before the audit has been completed. The availability of both "tick-and-tie" and negative assurance comfort for fiscal year-end numbers may be impacted until the audit is considered "substantially complete," which often means that the company is all but ready to issue its complete audited financial statements. To the extent desired comfort is unavailable, the underwriters may be willing to accept a certificate from the company's chief financial officer attesting to certain financial information included in the offering document. The form of any such certificate should be tailored to the specific situation.

Flash Numbers May Need to Be Furnished on a Form 8-K – Item 2.02 of Form 8-K requires a company to "furnish" a Form 8-K containing any material nonpublic information regarding the company's results of operations or financial condition for a completed quarterly or annual fiscal period that the company or any person acting on its behalf discloses in a public announcement or release. SEC Exchange Act Form 8-K Compliance and Disclosure Interpretation 106.07 specifically requires a Form 8-K in the case of "preliminary" earnings disclosure for a completed quarterly period, even if some of the amounts are only estimates. An additional Form 8-K would be required when the final results are publicly disclosed or when revised amounts are publicly disclosed. While the disclosure of information in the context of an unregistered offering (*e.g.*, a Rule 144A offering) may not constitute a "public announcement or release," disclosure of flash numbers in a private offering memorandum may trigger required public disclosure under Regulation FD, as further described below. Therefore, a public company would be well advised to furnish an Item 2.02 Form 8-K even for disclosure in a private offering memorandum.

Don't Forget About Regulation FD – Providing flash numbers in a prospectus or private offering memorandum may trigger required public disclosure under Regulation FD for public companies. The standard procedure is to file a Form 8-K including the flash numbers substantially simultaneously with the launch of the offering. The offering constituents should ensure that such a press release is drafted in a manner to avoid it being considered an "offer" of the securities under the U.S. federal securities laws. Private companies that have previously issued securities pursuant to Rule 144A should consider making any such results simultaneously available on their website or in the dataroom established to comply with Rule 144(d)(4) in order to remove information asymmetry as between potential investors in the new offering and existing and potential investors in the company's existing securities.

What If I Can't or Don't Want to Disclose Flash Numbers and Can't Wait?

Because disclosing flash numbers is not completely free from risk, a company that needs to raise funds but either cannot or does not want to disclose the financial information needed to satisfy its disclosure obligations should consider, if the

necessary facilities or programs are in place, borrowing under available bank facilities or issuing commercial paper and subsequently refinancing such borrowings after earnings are reported. While issuances of commercial paper are still subject to potential liability under Rule 10b-5, many companies gain comfort with the immateriality of quarterly earnings in the context of commercial paper issuances.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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