Securities Offerings During Blackout Periods and Following a Quarter-End: What You Need to Know

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Many companies voluntarily impose a “blackout period” beginning around the time a quarter ends and continuing through the quarter’s earnings announcement or subsequent 10-Q or 10-K filing. Although the company’s directors and officers are therefore barred by company policy from trading during this period, it may nevertheless be possible for the company or its major stockholders to complete a securities offering on a public or private basis. The existence of a company-imposed blackout period does not, as a legal matter, prevent the company or a major stockholder from selling securities as long as the company is able to meet its duty of disclosure.

This memo discusses what factors company management and their underwriters should consider when contemplating a securities offering during a blackout period. We focus particularly on US companies that are already subject to SEC reporting requirements and that are up-to-date with their filings – IPO companies, companies not subject to SEC reporting and companies that are behind in their SEC filings will have additional matters to consider.

A note of caution is appropriate – this memo offers a blinking-yellow light, not a green light. In many cases the best course of action will be to schedule the offering after the 10-Q or 10-K is filed. Nevertheless, in a period of rapidly shifting investor receptivity to new issues, a company and its underwriters may decide that the balance of considerations favors moving more quickly to market.

What is a blackout period and why do companies impose them?

For a US public company that is timely in its SEC reports, there are no mandated blackout periods (with one exception, discussed below). The SEC regulatory scheme generally provides that a company that is timely with its SEC reports can always use those SEC reports as the basis for its public disclosure and offer securities freely.

There is one exception to this rule: for a company doing an offering that is not off of an effective shelf, the SEC generally does not permit the company to rely on its public disclosure beginning 45 days after year-end until its 10-K is filed, although it will allow the company to do so if it has generated a profit in recent years and expects to report profits for the just-completed year.

However, the SEC prohibits insiders from trading based on any material non-public information (or “MNPI”) they have obtained from the company. Accordingly, insiders who wish to sell securities typically require clearance from their general counsel before trading to ensure they don’t possess MNPI. To protect insiders from regulatory investigations and to avoid forcing the general counsel to make a call when the facts may be developing rapidly, most companies impose a blackout period during which insiders cannot trade, and this period often starts at a time around quarter-end just before the company and its insiders are likely to possess MNPI. But, importantly, this is a prophylactic measure, not a hard-and-fast rule imposed by the SEC.

Can an offering be completed during a blackout period?

It may be possible to complete a securities offering during a blackout period when:

- management has enough information about the current (or recently ended) quarter to be able to predict with a fair degree of confidence what the company’s reported results are likely to be,

- management has a good track record of being able to judge its anticipated results at similar points in the information-gathering and reporting cycle, and
- management's expectations for the quarter, and future periods, are at least in line with "the market's" expectations as well as with management's own previously announced guidance (if any) – or if not, the company and its underwriters conclude that the deviation is not material (most likely to occur in a debt offering), or the company is willing to "pre-release" its current expectations prior to the earnings release. (Of course, as with an offering conducted outside a blackout period, it is also necessary to make sure there is no other MNPI (such as a significant pending M&A transaction), or if there is, to disclose it publicly.)

Management's information. The inquiry into management's current information should normally include careful diligence focusing on the "known knowns" and the "known unknowns," and an effort to quantify the "known unknowns" is usually essential. The "unknown unknowns," of course, cannot be quantified, and for this reason *all participants in the transaction must understand and accept that there is some quantum of risk – reputational as well as legal – that cannot be excluded when conducting a securities offering in the period leading up to the company's formal announcement of results.* Some companies have systems (such as flash reports) to track performance weekly, or even daily, and have a strong grasp on what is happening on a near real-time basis. Other companies may experience more of a lag before negative information or a developing negative trend becomes apparent to management – the "unknown unknowns" would be more of a concern here.

Management's track record. An assessment of management's track record can sometimes be informed by comparing the company's earnings or other forward-looking guidance to its reported results for the last several quarters, in order to get a sense of whether the company has a history of "underpromising and overperforming," or vice versa. Not all companies provide public guidance, however. For companies in either camp, it is usually helpful to have a working group discussion focusing on where the company is in its information-gathering and reporting cycle, and whether it is currently at a point, based on past experience, to be able to forecast results with some degree of accuracy.

Market expectations. Market expectations are not always easy to discern, and there is no single way to go about determining them. Many working groups will start with services such as Thomson Reuters First Call, or another service that aggregates the published views of securities analysts, in order to determine the "consensus" view for the current (or recently ended) quarter, the full year and sometimes the next year. Because the consensus is usually reported as an average (whether of estimates of future revenues, earnings, EPS or EBITDA, or other metric closely followed in the company's industry), it is usually helpful to look beneath the consensus to see whether it is being driven up or down artificially by an analyst or two who may be an outlier. Likewise, if the company will meet market expectations largely because of one or more factors that the market is unaware of, or may be aware of but is likely to discount (such as a one-off or non-operating gain), and the company would be below expectations if its results were based only on the factors normally incorporated in the analysts' models, the working group may decide that the company is not clearly and comfortably meeting market expectations despite a superficial similarity.

Because most analysts do not update their published views more frequently than quarterly, sometimes the "consensus" may be outdated. As an example, if the company is a steel manufacturer and its earnings will deviate from consensus simply because steel prices have dropped since the analysts last published, the working group could conclude that investors will not be surprised by the deviation. In similar situations, the working group should try to understand whether the reason the company is likely to deviate from consensus is something that ought to be apparent to the investing public, or is instead based on information not available to the market.

Beyond looking at the numbers, the company and its underwriters should consider any other available information, such as:

- the company's understanding of where investors and analysts are currently focused,
- the views of coverage bankers involved in the transaction,
- recent announcements by industry peers or others that may be recalibrating market expectations, and
- the views of any sell-side analysts who are "over the wall" – i.e., an analyst employed by an underwriter involved in the transaction who has been informed about it. Because an analyst who is brought over the wall is usually prohibited from speaking to investor clients about the company until the transaction has been publicly announced, it is generally not customary to bring analysts over the wall until shortly before announcement.

A company that does not provide public guidance may reasonably ask why market expectations about the company's upcoming earnings announcement should be relevant to the question of whether it can conduct a securities offering. The issue is whether or not investors are likely to be disappointed when the company announces earnings. Even if the company does not provide guidance, the market still has expectations; the fact that those expectations were not informed by the company's own guidance is a nuance that may be lost on the disappointed investors (and lawyers who specialize in filing lawsuits on their behalf).

What if management's expectations are not in line with the market's?

If management's expectations for the quarter are not in line with (or better than) the market's, many companies will decide to put off a securities offering until after earnings are announced or the 10-Q or 10-K is filed. For a company that is nevertheless prepared to proceed, the company and its underwriters should agree on a strategy for recalibrating the market's expectations. This involves two decisions: what to say, and how to say it.

What to say. This, of course, turns primarily on the facts. Frequently, the issue is simply a non-trivial risk that one or more of the company's reporting metrics will be lower than the market's current expectations. Sometimes this can be solved simply by disclosing or highlighting a fact or trend (such as a slowdown in orders from a major customer) that the market has not previously considered or that analysts appear to be ignoring. Often, the company cannot say precisely what it will report in a few weeks, but is fairly certain that the market's expectations are above the range of reasonably likely outcomes; in this case it may be appropriate to disclose that range.

How to say it. Because of the sensitive nature of information about a gap between management's and the market's expectations, the communication strategy should take into account the requirements and spirit of Regulation FD – even when there is a technical Regulation FD exemption, as may be the case with a public offering. Thus, companies will often announce the new information in an 8-K filed immediately prior to launching the transaction. If the quarter-end has passed, disclosure under Item 2.02 may be needed; otherwise an Item 7.01 8-K may suffice – but in either case the 8-K itself would not usually be incorporated into the prospectus or other offering document for the transaction. Whether to also include the information in the offering document and/or road show materials is a subject for working-group discussion. When the information includes forward-looking statements, the working group may conclude in some situations that it is preferable to leave it out of the offering materials.

What else should the working group consider?

Reputational risks. All offering participants – the company and company management as well as the underwriters – risk damage to their reputations if an offering is conducted and the company's

subsequently reported results disappoint investors in the offering. This is the case whether or not the company felt it needed to disclose new information in order to reset the market's expectations.

Legal risks. A materially disappointing earnings release issued after an offering can be an invitation for a lawsuit, which of course is distracting and potentially costly even if not well-founded. The working group should bear in mind that whether there's a "material" difference between the company's offering-related disclosures and its subsequently announced results is a question that will be judged with hindsight – based at least in part on how the market reacts when the results are made public.

On a related note, the company's accountants generally will not be in a position to provide "comfort" with respect to ranges or projections, and may be unable to provide comfort with respect to periods of a few weeks before and after the quarter-end. Similarly, prior to filing the 10-Q or 10-K, the company's accountants are generally unable to provide a formal review or audit of financial information for the quarter or year. In a subsequent lawsuit, therefore, the offering participants may not have the full benefit of an accountant's comfort letter to help establish their due diligence defense. Underwriters will therefore often seek to document and substantiate their diligence of ranges, projections, earnings-release information and other financial information about the quarter through alternative means, such as by obtaining a CFO certificate attesting to numbers or ranges included in the offering document or having a confirmatory conversation with a member of the company's audit committee, in addition to obtaining the company's representations and warranties in the underwriting or purchase agreement. Whether or not additional diligence procedures are available, close attention to the diligence defense is a good idea, including a robust process of vetting management's expectations and underlying assumptions for the quarter and future periods with the participation of the working group.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Sarah E. Beshar	**212 450 4131**	sarah.beshar@davispolk.com
Maurice Blanco	**212 450 4086**	maurice.blanco@davispolk.com
Julia K. Cowles	**650 752 2007**	julia.cowles@davispolk.com
John G. Crowley	**212 450 4550**	john.crowley@davispolk.com
Frank S. Currie	**650 752 2002**	frank.currie@davispolk.com
Bruce K. Dallas	**650 752 2022**	bruce.dallas@davispolk.com
Alan Dean	**212 450 4126**	alan.dean@davispolk.com
Alan F. Denenberg	**650 752 2004**	alan.denenberg@davispolk.com
Richard A. Drucker	**212 450 4745**	richard.drucker@davispolk.com
Manuel Garciadiaz	**212 450 6095**	manuel.garciadiaz@davispolk.com
Joseph A. Hall	**212 450 4565**	joseph.hall@davispolk.com
Michael Kaplan	**212 450 4111**	michael.kaplan@davispolk.com
Daniel G. Kelly, Jr.	**650 752 2001**	dan.kelly@davispolk.com
William M. Kelly	**650 752 2003**	william.kelly@davispolk.com
Deanna L. Kirkpatrick	**212 450 4135**	deanna.kirkpatrick@davispolk.com
Nicholas A. Kronfeld	**212 450 4950**	nicholas.kronfeld@davispolk.com
John B. Meade	**212 450 4077**	john.meade@davispolk.com
Thomas J. Reid	**212 450 4233**	tom.reid@davispolk.com
Richard J. Sandler	**212 450 4224**	richard.sandler@davispolk.com
Sarah K. Solum	**650 752 2011**	sarah.solum@davispolk.com
Mischa Travers	**650 752 2014**	mischa.travers@davispolk.com
Richard D. Truesdell, Jr.	**212 450 4674**	richard.truesdell@davispolk.com
Martin A. Wellington	**650 752 2018**	martin.wellington@davispolk.com
Marcel Fausten	**212 450 4389**	marcel.fausten@davispolk.com
Janice Brunner	**212 450 4211**	janice.brunner@davispolk.com

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