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ALERT MEMORANDUM

Estonian IPOs – Key Issues for Market Participants

January 22, 2019

While Estonia has experienced significant economic development during the past three decades, its capital markets have not grown in the same way. The market capitalisation of Tallinn Stock Exchange (the country's only regulated market) is approx. EUR 2.6 billion[1] (corresponding to only approx. 10% of GDP, one of the lowest ratios in the EU)[2]. With only 15 companies currently listed on the main equity list of Nasdaq Tallinn, the supply for investors seeking to purchase publicly traded equity of Estonian companies has to date been limited. To tackle the above concerns and spark further interest in capital markets activity in Estonia, the Estonian government has begun to contemplate the privatisation of minority stakes in several state-owned entities. The IPO of Tallinna Sadam (the Port of Tallinn), on which Cleary Gottlieb and Sorainen acted as international and Estonian counsel (respectively) to the underwriters, was the first such project. Successfully completed in June 2018, it involved a public offering to retail investors located in Estonia and an international offering to institutional investors, including in the United States.

Though the Estonian legislative framework generally follows the EU Prospectus Directive,[3] the successful execution of an IPO in Estonia involves a number of practical complexities. This memorandum outlines some of the key international and Estonian legal considerations arising in such a transaction.

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[1] Based on data (as of December 2018) from the Nasdaq Baltic website: https://www.nasdaqbaltic.com/market/?pg=capital&lang=en

[2] Based on Q3 2018 data from the Estonian Central Bank.

[3] Prospectus Directive 2003/71/EC, as amended by PD Amending Directive 2010/73/EU (the "**Prospectus Directive**").

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OFFERING STRUCTURE AND DOCUMENTATION

Institutional and retail components

In Estonia, there is no requirement that an offer of equity securities include a domestic offering to retail investors. An Estonian company may therefore make such an offer solely to international investors, without any local retail element. However, to deepen its pool of potential investors, a company may wish to offer its equity securities to members of the public, as well as institutional investors internationally ("dual-tranche" offerings).

The Port of Tallinn IPO was a dual-tranche offering, involving (1) a domestic offering to retail investors in Estonia and (2) an institutional offering to qualified institutional buyers in the United States under Rule 144A under the U.S. Securities Act of 1933 (the "**Securities Act**"), and outside of the United States in reliance on Regulation S under the Securities Act. The offering raised total gross proceeds of EUR 147.4 million, with allocations to retail investors amounting to 21.2% of the total offering size.

A dual-tranche structure introduces challenging issues to the IPO process, arising principally from the nature of the offering documentation and the contractual arrangements that must be put in place between the issuer, potential selling shareholders and the banks coordinating or underwriting the transaction. Consideration must also be given to the settlement mechanics of the offering. These matters, each of which will be discussed in this memorandum, should be considered by the IPO working group early on in the process to ensure effective execution of the transaction.

Offering Documentation

Before the offer period commences, the issuer is required to register a prospectus with the Estonian Financial Supervision Authority (the "**EFSA**"). In Estonia, no public marketing of the offering or the shares of the issuer is allowed before the prospectus has been approved by the EFSA and, as such, the intention-to-float announcement ("**ITF**") for the IPO can only be published after such approval has been obtained. Note, however, that it is permissible to publish the ITF prior to the actual publication of the prospectus.

This requirement stems from a specific provision in Estonian securities law,[4] which is generally interpreted as having the intention of improving investor protection and market integrity by preventing information about public offerings being disseminated in the public domain prior to regulatory approval. However, a tension exists between this provision, which requires the approval of an incomplete document at the date of the announcement of the transaction (and so before the provisional terms of the offering have been set), and the Prospectus Directive, under which a prospectus approved by the local regulator – and containing the price range of the offering – must be approved (and published) for the purposes of marketing to retail investors.

To reconcile these competing considerations, the approach taken in the case of Port of Tallinn was for an initial (full) prospectus to be registered with, and approved by, the EFSA at the time of the ITF; this prospectus omitted the price range (and related) information, as such information was not yet available. A prospectus supplement containing the price range was subsequently filed with – and approved by – the EFSA, and published (together with the initial prospectus) at the launch of book-building. In this way, investors effectively received at such time a complete "price-range prospectus", approved by the Estonian regulator and in line with the requirements of both the Estonian Securities Market Act and the Prospectus Directive. Following pricing, a pricing statement was conveyed to investors to complete the disclosure package, and "time of sale" occurred for U.S. securities law purposes.

While such a process differs from typical international practice, it is not dissimilar from the way equity offerings (with an analyst presentation) in London have been conducted since the introduction, effective as of July 1, 2018, of new Conduct of Business Sourcebook ("**COBS**") provisions issued by the UK Financial Conduct

[4] Section 31(4) of the Estonian Securities Market Act.

Authority. These essentially require issuers to publish an approved registration document or a prospectus before the publication of research reports by connected and unconnected analysts, which has led to transaction announcements (so-called, "pre-ITF" announcements) taking place earlier than the market has been used to in prior IPOs.[5]

Additional retail offering documentation

As noted above, one particular area which arises for consideration in the dual-tranche offering context is what additional documentation, if any, beyond the approved prospectus will be used to market the domestic public offering.

While practice varies by jurisdiction as to the nature and scope of such documentation (leaflets or brochures being two examples thereof), this will likely be summary in nature. Prominent reference to the approved prospectus published by the issuer (and where this can be obtained) should be made in any such documentation. From a U.S. securities law perspective, consideration will need to be given to how such materials are disseminated, to ensure that safe harbors from U.S. registration requirements are available (for example, documentation published on the issuer's website is often placed behind a web filter, requiring the viewer to certify its residence outside the U.S. before they can be accessed).

The general rule under Estonian law is that any advertising of the offering, including information not disclosed for advertising purposes, must contain only information included in the prospectus and may not be incorrect or misleading. It must also direct investors to the place of publication of the prospectus. All advertisements made in connection with the offering (including any public announcements and information made available via the Internet for marketing purposes) are subject to the EFSA's review before publication. While the EFSA need not expressly authorize the advertisement ahead of its publication, it can establish specific requirements for its content or, if necessary, prohibit the dissemination altogether.[6]

The EFSA has traditionally been keen to ensure that the prospectus (together with its local language summary) remains the primary source of information for investors. With that in mind, in practice it tends not to encourage publication of any leaflets or brochures that summarise the main terms of the offering in a manner that resembles an advertisement, even if a description of risk factors is included.

UNDERWRITING SYNDICATES AND DOCUMENTATION

Syndicate structure

While a dual-tranche offering in Estonia consists of distinct components corresponding to each tranche, there may not necessarily exist two separate syndicates of banks. The institutional tranche can involve, as is typical, one or more international investment banks which will market and coordinate the offering to institutional investors. By contrast, retail investors are able to participate through any local bank or custodian in Estonia (of which there are more than twenty). In practice, one or more local banks are appointed as retail offering coordinator(s) and will enter into a specific agreement with the Estonian central securities depositary, through which instructions are sent to all custodians regarding subscriptions or the settlement process.

Irrespective of the number of syndicates, there are many issues to be considered when putting in place the contractual arrangements to coordinate the relationship between the two tranches. These should cover matters such as selling restrictions, settlement procedures, the allocation of commissions, stabilization of the shares offered in each tranche, the re-allocation of shares from one tranche to the other and, most importantly, the inter-conditionality of both offerings. It may be possible to achieve this using solely the underwriting agreement (where, for example, each international bank and retail offering coordinator is involved in the underwriting of the institutional offering). Alternatively, where the retail offering coordinators have no involvement outside the retail tranche itself, additional arrangements may be required to deal with these issues, such as an inter-syndicate agreement.

[5] For further details on the new COBS provisions, please refer to Cleary Gottlieb's memorandum, available here.

[6] Section 31(6) of the Estonian Securities Market Act.

Underwriting agreement

Institutional offering

In a Regulation S/Rule 144A offering to institutional investors without a retail tranche, the underwriting agreement is usually signed at the time of transaction pricing (after the completion of book-building). By contrast, in listings with a retail tranche it is more common for the underwriting agreement to be signed at the start of book-building (*i.e.*, the date on which the prospectus is approved and published), although the underwriting commitment of the banks is contingent on the execution of a subsequent agreement at pricing.

In this way, the underwriters obtain the benefit of the issuer's and/or selling shareholders' representations and warranties (specifically those regarding the truth and accuracy of the prospectus), but their underwriting obligations remain contingent on the book of investor demand having been successfully built. In spite of this divergence, in both such cases the underwriting banks take only "settlement risk" in respect of the institutional offering, since underwriting commitments (which are crystallized through the execution of a pricing memorandum by the parties to the underwriting agreement in the dual-tranche offering context) are only made at pricing, by which point investor demand is known and the book of demand has been fully covered.

Retail offering

As described above, it is practical to have the retail tranche coordinated by one or more local banks. In practice, any commitments made by retail investors during the offering period (stated in terms of a number of shares) will trigger the blocking of funds in investors' bank accounts, at the top of the price range (and so funds are, in that sense, assured).[7]

STABILIZATION

To support the price of the shares in the event that the price falls in the aftermarket, one of the banks in the syndicate is usually mandated to act as stabilization manager. There is no requirement under Estonian law for the stabilization activities to be performed by a local bank, but such division of roles may nevertheless be necessary for practical reasons. In particular, international banks may not be members of the Nasdaq Tallinn, thus making it difficult for them to fulfil the reporting requirements of Commission Regulation 2016/1052/EU on buy-back programmes and stabilization measures (the "**Stabilization Regulations**"), and in turn to benefit from the safe harbor under the Market Abuse Regulation 596/2014/EU. In any case, as stabilizing activities are a regulated service under MiFID II,[8] the manager undertaking stabilization needs to have the necessary authority to engage in investment services in Estonia (either through passporting its activity licence or, in limited cases, relying on an applicable exemption). These arrangements will need to be fully disclosed, in line with the requirements of the Stabilization Regulations.

In terms of structures relating to stabilization, a "greenshoe" is the most conventional option in Central and Eastern European transactions (this refers to the creation of a short position, typically settled using a share borrowing, intended to assist stabilization activities, with the short position being closed out through market repurchases or the exercise of an option to purchase, at the offering price, shares from the original share lender). However, for projects involving the Estonian Republic as the selling shareholder, it is important to note that the Estonian State Asset Act, which governs transactions with state assets, does not specifically contemplate any possibility that the State may temporarily lend securities, and the legal basis for such a transaction to be made with the State's assets is uncertain. As such, the more conventional "greenshoe" option is unlikely to be the preferred solution in Estonia. Instead, a "brownshoe", or "reverse greenshoe" construct can be used.[9] In this structure, a portion of the proceeds from the offering is withheld at closing and used to effect stabilizing purchases up to a specified amount in the aftermarket, with any shares purchased in the course of stabilization (together with any unused proceeds)

[7] For example, for an offering with a price range set at EUR 1 – 2, an investor giving a commitment to subscribe for 100 shares will cause EUR 200 to be blocked. If the transaction prices at EUR 1.50 per share, the investment made will be EUR 150; EUR 50 is returned to the investor.

[8] Directive 2014/65/EU, as amended.

[9] This was used in the Port of Tallinn IPO.

being transferred back to the issuer/selling shareholder, as applicable, at the end of the stabilization period. Careful consideration (and commercial agreement) will be needed as to how any "stabilization profits" are shared.

The stabilization period would, in the case of a listing on Nasdaq Tallinn, last for 30 calendar days following commencement of trading.[10]

SETTLEMENT

The Estonian Commercial Code (the "**Code**") establishes a relatively flexible procedure for issuing and registering new shares by listed companies during secondary issues and by companies aiming to carry out an IPO and list shares on the stock exchange. The Code contemplates that shareholders will approve the terms and maximum volume of new shares to be issued, and will authorize the board to carry out the issuance. The issuance will subsequently be registered as a conditional share capital increase at the Estonian Commercial Registry. The conditionally issued shares carry a temporary ISIN, which will be changed into a permanent ISIN after completion of the settlement (*i.e.*, delivery of the shares to the investors against payment for the shares by the investors).

However, this technical step causes a practical concern: while it takes several days for the securities accounts to reflect the ISIN change (and longer in the case of more complex custody chains), market expectation is that trading in the shares will commence and investors are able to actively trade on the day directly following settlement. A solution is for one or more of the syndicate of banks to pre-fund the issuance of primary shares (by paying the issue price for all the new shares to be issued once the size of the primary tranche is known). In such a case, the ISIN of the shares can be changed prior to the shares being transferred to the various securities accounts of the investors, shortening the time needed for completion of the technical process.

The success of Port of Tallinn IPO, together with certain favorable market conditions and other initiatives to develop capital markets in the region, has created a sense of optimism that, it is hoped, will pave the way for similar transactions in the future. One noteworthy initiative is the development of the Baltic capital markets union – supported by both the European Commission and the European Bank for Reconstruction and Development – with the aim of harmonizing capital markets regulations and dismantling investment barriers. This is a particularly important aim given the limited size of the Estonian, Latvian and Lithuanian markets, respectively. The commitment to a capital markets union was recently reaffirmed by the finance ministries of all three Baltic countries, who were represented at the Pan-Baltic Capital Market Conference, which took place in London on October 18, 2018.

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[10] No dealing on a conditional basis is permitted on Nasdaq Tallinn.