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Impact of Securities Offering Reform on Underwriting Arrangements

The SEC's securities offering reforms significantly alter aspects of the public offering process. New offering procedures impose new conditions and obligations for issuers and offering participants, accompanied by potential liability. The changes in offering procedures and related liability considerations are likely to result in revised underwriting-related agreements.

by Stephanie Tsacoumis

The SEC recently adopted final regulations implementing the securities offering reforms that were proposed in November 2004.[1] Not only will these regulations significantly impact public offerings, especially for large, well-known public companies, but they also will have liability implications affecting the legal relationships between the issuer and underwriters. Forms of underwriting and related agreements inevitably will need to be revised to reflect the new offering procedures as well as changed liability considerations. While the new rules liberalize aspects of the offering process, they also impose conditions and requirements. Taking advantage of some of the new regulatory provisions could result in additional liability for issuers and underwriters.

Pre-Filing Communications

The new rules liberalize permissible pre-filing communications, particularly for "well known seasoned issuers" (WKSIs).[2] The rules also establish a safe harbor for communications made more than 30 days before filing a registration statement.[3] The conditions and requirements relating both to WKSI pre-filing offers and 30-day safe harbor communications along with the associated potential liability will require advance planning and coordination by issuers and underwriters.

Under the new rules, if certain conditions are met, WKSIs may engage in unrestricted oral and written offers before a registration statement is filed. These communications would be exempt from the prohibition under Section 5(c)[4] on offers before a registration statement is filed.[5] Written pre-filing offers must contain a prescribed legend and, subject to some exceptions, must be filed with the SEC promptly at filing the registration statement.[6]

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While exempt from the prohibitions on "gun-jumping," such written pre-filing offers would be statutory prospectuses subject to the anti-fraud provisions of the federal securities laws, including Section 12(a)(2) liability.[7] Oral pre-filing offers also would be subject to liability under Section 12(a)(2).[8]

Although the enhanced ability of WKSIs to communicate with prospective investors before filing a registration statement will be appealing from a marketing perspective, issuers and underwriters should consider the benefits in light of the liability implications of such communications. Issuers should anticipate careful underwriter examination of pre-filing communications as a diligence matter. Issuers also should anticipate that the accuracy and regulatory compliance of pre-filing communications will be addressed, either specifically or as a general regulatory compliance matter, in underwriting agreement representations and warranties.

The new safe harbor for communications made more than 30 days before registration statement filing applies to communications made by or on behalf of the issuer. [9] Such communications will not constitute an "offer" in violation of Section 5, provided they do not reference a securities offering that will be the subject of a registration statement and provided that the issuer takes "reasonable steps within its control" to prevent further distribution of the information within the 30-day period before filing.[10] Communications that qualify for the 30-day safe harbor will be subject to anti-fraud provisions.[11]

One potential problem area in implementing the 30-day safe harbor relates to the adequacy of issuer efforts to prevent further distribution of a communication within the 30-day period. Not only is a "reasonable efforts" standard subjective, but the SEC adopting release presents easily imaginable scenarios for which the safe harbor would not apply. For instance, if an executive gives an interview to the press before the 30-day period and the interview is published within the 30-day period, the safe harbor will not apply, even if neither the issuer nor the executive had any post-interview contact with the press.[12] Furthermore, the safe harbor is only available to issuers; other offering participants cannot use the exemption.

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Issuers as well as underwriters should take these limitations into consideration in planning and monitoring pre-filing communications. Non-WKSI issuers who seek to rely on the 30-day safe harbor may not reference an anticipated registered offering, and therefore cannot use such communications to "test the waters." Such issuers also must take and document efforts to prevent further distribution of the communication during the 30-day period.

Free Writing Prospectuses

Under the new rules, after a registration statement is filed, issuers and underwriters may make written offers by distributing "free writing prospectuses" (FWPs).[13] FWPs could consist of communications as varied as emails, Web sites, written media reports, term sheets, and recorded road shows. A third party communication based on issuer-provided information, such as an article that includes information obtained at a road show, also could be a FWP.[14]

If the issuer is "eligible," the offering meets certain requirements and specified legend, filing, prospectus delivery, and retention requirements are satisfied,[15] a FWP will not violate the prohibitions on non-conforming prospectuses before effectiveness.[16] Although FWPs may not contain information that "conflicts with" any registration statement information,[17] FWPs are not subject to any line-item disclosure requirements.

Of particular note are the filing requirements relating to FWPs. Not only will issuers be required to file issuer-prepared FWPs, issuers also will be required to file certain underwriter-prepared FWPs, including:

- Underwriter-prepared FWPs that the issuer refers to or distributes,
- Underwriter-prepared FWPs that include material information about the issuer provided by or on behalf of the issuer, and
- Underwriter-prepared FWPs that the issuer reviews and approves.[18]

Underwriters also have filing requirements relating to FWPs. Underwriters are required to file FWPs that are distributed in a manner reasonably designed to lead to "broad unrestricted dissemination." Including an underwriter FWP on an unrestricted web site, for instance, would trigger an underwriter filing requirement.[19] Inadvertently emailing an underwriter FWP to a list of recipients not limited to broker-dealer customers also could trigger filing.

Although the rules do allow for cure of unintentional failures to file, the penalty for failure to comply with filing requirements (or to cure noncompliance) is severe–a Section 5 violation, with rescission as a potential remedy. Careful recordkeeping and compliance monitoring therefore will be important.

Both issuers and underwriters could have potential liability under Sections 12(a)(2) and 17(a)(2) of the Securities Act for FWPs.[20] FWPs also will be subject to the anti-fraud provisions of the federal securities laws.[21] Because FWPs are not required to be filed as part of the registration statement, however, Section 11 liability will not apply unless the FWP is filed as part of, or incorporated into, a registration statement.[22]

A critical FWP-related issue for underwriters relates to potential liability for FWPs prepared by the issuer or other offering participants. In response to comments on the proposed regulations, the SEC clarified that an underwriter or other offering participant will not be considered to offer or sell securities by means of a FWP solely because a FWP has been used or filed with the SEC; rather, the underwriter must have some involvement in the preparation or the FWP or must have used or referred to the FWP. Specifically, under the new rules, an underwriter (or other offering participant) will not be considered to offer or sell securities "by means of" a FWP unless:

- The underwriter "used or referred to" the FWP in offering or selling securities;
- The underwriter sold securities to a person and "participated in the planning for the use of the FWP" that was used by another offering participant to sell securities to that person;[23] or
- The underwriter was otherwise required to file the FWP. [24]

Although the SEC intended for these provisions to address concerns about cross liability for FWPs used by issuers and offering participants,[25] uncertainty remains. For instance, one approach to monitoring FWPs and ensuring regulatory compliance is to require lead underwriter approval of or consent to FWPs used by syndicate members or other offering participants. Whether such approval or consent constitutes "planning for the use" of the FWP, creating potential liability is not clear, however. Arguably, while approval may imply some control over or "adoption" of the FWP,[26] consent involves a lesser degree of involvement. To take another example, whether underwriter participation in planning for the use of FWPs in connection with road show presentations establishes the predicate for liability also is unclear.

As a result of continuing uncertainty about cross liability, underwriters and issuers are well advised to consider a variety of approaches to FWPs and to document an agreed-on understanding in the underwriting-related agreements. Depending on the circumstances and applicable liability concerns, issuers or underwriters may want to avoid FWPs entirely. Alternatively, the parties may wish to permit FWPs, but only if the issuer or the lead underwriter, or both, consent. To mitigate the uncertainty about the liability implications of "consent" described, consent rights could be limited to legal compliance or could be qualified by a "not to be unreasonably withheld" standard. Another possibility is for the parties to agree to specified procedures relating to FWPs or the information contained in FWPs. At a minimum, if FWPs are permitted, underwriters and issuers will want the other parties to identify FWPs to ensure their respective compliance with filing requirements. Additionally, not only will the parties have an interest from a diligence and liability perspective in reviewing the accuracy of information contained in FWPs, the parties also will want to verify compliance with the requirement that FWP information not "conflict with" information

in the registration statement or previously filed Exchange Act reports.

Similar cross-liability concerns may exist among syndicate members and the lead underwriter. As a result, syndicate members and lead underwriters may avoid FWPs, may permit FWPs subject to certain requirements or to review and consent procedures, or may permit FWPs coupled with contractual provisions (in agreements among underwriters or otherwise) that address the respective potential liability of syndicate members and the lead underwriter.

Liability at the Time of the Investment Decision

The new rules codify the SEC interpretation that Section 12(a)(2) and Section 17(a)(2) liability will be tested at the time of the "contract of sale"[27] based on information "reasonably available" to the investor. Information delivered after the investor makes an investment decision by entering into the contract for sale is not to be taken into account in assessing disclosure for this purpose. As a result, preliminary prospectuses will take on heightened legal importance.[28] Corrections or changes later contained in the final prospectus will not be relevant for Section 12(a)(2) and Section 17(a)(2) liability purposes.[29] Therefore, in addition to addressing Section 11 liability at the time of registration statement effectiveness (and on the dates prescribed by new Rules 430B and 430C with respect to prospectus supplements), underwriting arrangements will need to address the increased importance of, and liability relating to, preliminary prospectuses.

The practice of requesting 10b-5 "comfort" on the adequacy of final prospectus disclosure also is likely to be reconsidered; underwriters may wish to request similar assurances for information conveyed to investors at the time of the contract of sale. Underwriting agreements thus may well be revised to add a requirement for 10b-5 assurances relating to the preliminary prospectus used at the time of the contract of sale.

Liability for Information in Prospectus Supplements

The new rules confirm that information contained in prospectus supplements will be considered part of the related registration statement for Section 11 liability purposes.[30] Section 11 liability will be assessed as of the date that the prospectus supplement is "first used"[31] or, in the case of shelf offerings, the date of the first contract of sale of securities to which the supplement relates, if earlier.[32] Applicable definitions and provisions in related underwriting agreements should clarify that references to the applicable "registration statement" encompass related prospectus supplements. Conforming changes also may be required in representations relating to the content of registration statements and in indemnification provisions to reflect the date on which prospectus supplements are deemed part of the registration statement for Section 11 purposes.

Early Planning

The new securities offering regulations implement significant changes to various aspects of the offering process. Until a course of practice develops under the new rules, applicable procedures are likely to vary from offering to offering depending on the facts and circumstances. Because the new rules impact pre-filing and waiting period activities and because regulatory compliance and liability for such activities ultimately will be addressed in the underwriting agreement, early consideration by issuers and underwriters of offering procedures will be important.

Issues that should be discussed early in the process include the use of FWPs and pre-filing communications policies. Issuer classification is another early discussion issue. Many aspects of the new regulations hinge on the classification of the issuer as a WKSI,[33] "seasoned issuer,"[34] "unseasoned issuer,"[35] "non-reporting issuer"[36] or "ineligible issuer."[37] In anticipation of underwriters' diligence and underwriting agreement representations and warranties, issuers and underwriters should confirm early in the process the issuer's status under the various categories.

Also in anticipation of negotiating the underwriting agreement, the parties should discuss anticipated opinion or negative assurance requirements.[38] Underwriters may want opinion letters to address specific aspects of the new rules, such as eligibility for streamlined shelf registration. In addition, as discussed, underwriters may request opinions and negative assurances relating to regulatory compliance and disclosure documents at

the time of the contract of sale in addition to at the time of effectiveness.

Underwriting Agreements

Among the underwriting agreement provisions that may require revision as a result of the new securities offering regulations, the parties should consider the following.

Representations and Warranties

Nature of the issuer. The final offering rules classify issuers into four types based on the issuer's Exchange Act reporting history and equity market capitalization or amount of previously registered securities. Because many of the most significant reforms (such as "automatic shelf registration statements") apply to WKSIs, underwriters reasonably should expect an issuer representation and warranty relating to the issuer's classification, particularly if the issuer takes advantage of WKSI-oriented reforms.

Prospectus/registration statement. Underwriting agreements typically include an issuer representation that addresses compliance with applicable requirements of the registration statement (and any post-effective amendments) at the time of effectiveness. A similar representation generally is made with respect to the final prospectus.[39] In addition, a 10b-5 type representation regarding the contents of the registration statement and prospectus is almost uniformly included in underwriting agreements. These representations sometimes also address preliminary prospectuses. As a result of the new offering regulations, registration statement- and prospectus-related representations might properly be revised in several respects.

First, the new regulations make several additional time frames relevant to these underwriting agreement representations. Although the key time frame for Section 11 liability purposes continues to be effectiveness of the registration statement, representations relating to the registration statement also should cover the date of "first use" of prospectus supplements (or, with respect to shelf takedowns, the date of the first contract of sale relating to the prospectus supplement, if earlier). Additionally, because the touchstone for liability under Sections 12(a)(2) and 17(a)(2) is the time of the contract for sale, the time of the contract for sale should be the point at which the representations relating to the prospectus are made. A complicating factor is the possibility that a "contract for sale" may occur at several different points in time depending on the nature of the offering.

Second, the new regulations codify the SEC position that information delivered after the investor enters into a contract for sale will not be taken into account in assessing disclosure under Sections 12(a)(2) and 17(a)(2). Because a final prospectus is not delivered until after that time, liability will be predicated on disclosure in the preliminary prospectus. Underwriters therefore can be expected to ask for comprehensive representations and warranties relating to the preliminary prospectus in addition to the usual representations covering the final prospectus.

Third, references to the final prospectus and the preliminary prospectus should reference such documents as they may be supplemented by FWPs and WKSI pre-filing written offers under Rule 163. References to registration statements should encompass any prospectus supplements.

Fourth, underwriting agreements commonly include a representation stating that the issuer has included in the registration statement all required information other than information that permissibly is omitted under Rule 430A. This representation should be revised to take new Rules 430B and 430C into account.

Offering materials and FWPs. Issuers sometimes represent in underwriting agreements that they have not distributed any offering materials other than the preliminary prospectus, the prospectus and the registration statement. Similar representations, expanded to take into account liberalized communications under the new regulations, are likely to become much more common.

As suggested, pre-filing communications and the use of FWPs should be discussed by the parties, along with related procedures. If, for example, a WKSI has conveyed a pre-filing offer, the applicable communication might be identified in the representation (or a related schedule) and appropriate "anti-fraud" and regulatory compliance representations made.

Applicable approaches to FWPs include not permitting FWPs at all (and representing that no FWPs have been used), requiring consultation or consent before use of FWPs (and representing that such consents have been obtained), or simply identifying written communications other than the statutory prospectus (again, in the text of the representation or in a related schedule).

If FWPs have been used either by the issuer or offering participants, representations and warranties might address the accuracy and completeness of the FWP, as well as compliance with Rules 164 and 433, including completion of all necessary related filings.

Covenants

FWPs. The covenants section of underwriting agreements can be expected to include provisions relating to FWPs. Again, the appropriate provisions will be contingent on the intent of the parties with respect to use of FWPs. Possible FWP-related covenants could range from a mutual covenant prohibiting FWPs to mutual issuer and underwriter covenants not to use FWPs without consulting the other or without obtaining consent of the other. Another possible variation is an underwriter covenant not to use FWPs that include issuer-provided information. If FWPs are to be permitted, consideration also should be given to a covenant to comply with all regulatory requirements relating to FWPs, including filing and retention requirements.

Conditions to Closing

The liability aspects of the new rules suggest an expansion of the opinions and negative assurances that will be requested. In light of the significance of preliminary prospectus disclosure for Sections 12(a)(2) and 17(a)(2) purposes, opinions and negative assurances relating to the preliminary prospectus are likely to be sought. Likewise, based on potential liability for FWPs, WKSI pre-filing offers and prospectus supplements (as part of the registration statement), requested opinions and negative assurances are also likely to encompass FWPs, WKSI pre-filing offers and prospectus supplements.

Indemnification

Preliminary prospectus-related liability. Underwriting agreement indemnification provisions currently almost uniformly include issuer indemnification of underwriters for damages relating to preliminary prospectuses. Due to the increased importance of preliminary prospectuses under the new offering regime, underwriters will want to retain issuer indemnification for liabilities relating to preliminary prospectuses. Like other underwriting agreement references to preliminary prospectuses after the new rules, references to issuer indemnification for preliminary prospectuses should encompass preliminary prospectuses as they may be supplemented by FWPs and WKSI pre-filing written offers.

FWPs. Because FWPs and other communications can lead to underwriter liability, to the extent that FWPs are permitted, underwriters are likely to insist on issuer indemnification for issuer FWPs and for issuer-related FWP information. Similarly, issuers are likely to request underwriter indemnification for underwriter FWPs and underwriter-related FWP information.

Agreements among Underwriters

In addition to changes to underwriting agreements, revisions to forms of agreements among underwriters may result from securities offering reform. Just as potential cross-liability between issuers and underwriters for FWPs is likely to be addressed in underwriting agreements, potential cross-liability among underwriters, and syndicate members is likely to be addressed in agreements among underwriters. Agreements among underwriters also might address additional aspects of FWPs, including whether syndicate members will be permitted to use FWPs. In the same vein, provisions that restrict the use by syndicate members of advertising and supplemental materials could be expanded to specifically proscribe the use of FWPs.

NOTES

1. Securities Offering Reform, SEC Release Nos. 33-8591, 34-52056, IC-26993 (July 19, 2005) (Adopting Release).
2. *See* Adopting Release at 77-82; Rule 163. Rule references in this article are to provisions of 17 C.F.R. § 230.
3. *See* Adopting Release at 72-77; Rule 163A.

4. Section references in this article are to the Securities Act of 1933.

5. *See* Rule 163(a).

6. *See* Rule 163(b).

7. Written offers under Rule 163 also are "free writing prospectuses" under Rule 433. *See* Adopting Release at 79; Rule 163(d).

8. Adopting Release at 78-79, n.169.

9. Rule 163A.

10. Rule 163A(a).

11. Adopting Release at 74.

12. Adopting Release at 76—77, n.165.

13. Rule 164. *See also* Rule 433. These free writing prospectuses are deemed Section 10(b) prospectuses for purposes of Section 5(b)(1) of the Securities Act, if Rule 433 requirements are observed. Rule 164(a).

14. Adopting Release at 142 & n.321.

15. Rule 433 sets forth the conditions for use of a FWP, including prospectus delivery requirements, information and legend requirements and filing requirements.

16. Section 5(b)(1).

17. Rule 433(c)(1).

18. *See* Rule 433(d)(1)(i).

19. Adopting Release at 114.

20. Adopting Release at 187.

21. *See* Rule 10b-5 under the Exchange Act.

22. *See id.* at n.419.

23. This provision was not intended to encompass typical inter-syndicate arrangements providing for sales out of the syndicate "pot." Adopting Release at 150, n.339.

24. Rule 159A.

25. *See* Adopting Release at 150. Concerns include potential liability relating to the accuracy and completeness of information contained in FWPs as well as compliance with the filing and other requirements of Rule 433 to avoid Section 5 violations.

26. *See* Rule 159A(a), note 1 (if issuer "authorizes or approves" the information or communication, the information or communication will be deemed to be provided or made by the issuer).

27. Under the SEC interpretation, the time of contract of sale can be the time that the investor enters into the contract or completes the sale. *Id.* at 175, n. 394.

28. Liability would be predicated on the contents of the preliminary prospectus, as supplemented, including by free writing prospectuses, at the time of the contract of sale.

29. *See* Rule 412, Rule 430B. Section 11 liability attaches to final prospectus.

30. Rule 430B.

31. The date of first use is the date that the prospectus is first available to an underwriter or prospective purchaser. Adopting Release at 204, n.462.

32. Rule 430B, Rule 430C.

33. Rule 405.

34. *See* Form S-3; Adopting Release at 38.

35. *See* Form S-3; Adopting Release at 39.

36. *Id.*

37. Rule 405.

38. *See* Glazer, Donald, "Negative Assurance in Securities Offerings," *INSIGHTS* (October 2004).

39. The formulation for identifying the final prospectus varies among forms of underwriting agreements. The final prospectus may be described, for instance, as the prospectus filed under Rule 424(b), the prospectus used at the time of issuance of the securities, the prospectus in use at the closing time, the form of prospectus first used to confirm sales or the form first furnished to underwriters for use in connection with the offering.

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