Weil Briefing: Capital Markets

July 28, 2005

Securities Act Reform Becomes a Reality

Last week, the SEC published the text of significant deregulatory changes in the rules governing the conduct of registered securities offerings under the Securities Act of 1933, as amended. See Securities Offering Reform, SEC Release No. 33-8591 (Jul. 19, 2005)("Adopting Release"), available at http://www.sec.gov/rules/final/33-8591.pdf.[i] These changes, which we anticipate will become effective in early December 2005, implement major reforms in three general areas: (a) the mechanics of registered shelf offerings; (b) communications around the time of all registered offerings; and (c) final prospectus delivery.

The key reforms are summarized below, followed by a brief discussion of their liability implications.

Streamlining the Shelf Offering Process

- Perhaps most importantly from a company perspective, the new and amended rules deregulate the short-form shelf offering process significantly, by:
  - Creating an unprecedented "automatic" shelf registration mechanism for the largest companies filing reports with the SEC that meet certain eligibility criteria – a new class of widely held, "super-seasoned" companies termed "Well-Known Seasoned Issuers" ("WKSIs"). This will enable WKSIs to file a short-form registration statement that is effective immediately upon filing – thus enabling WKSIs to "file and go" to market without encountering the previous delay between filing and effectiveness of the registration statement that created an opportunity for SEC staff review;[ii] and
  - Streamlining the shelf offering process on a somewhat less extensive, but still beneficial, scale for a broader group of domestic and foreign companies eligible to make primary offerings of securities on Forms S-3 and F-3. Most notably, the SEC has eliminated volume and other restrictions previously imposed on equity "at-the-market" offerings, and permitted identification of selling securityholders by prospectus supplement (rather than post-effective amendment) under specified conditions.

Liberalize Communications

- Remove unnecessary technical barriers to written communications around the time of a registered securities offering by companies across a wide spectrum of sizes (measured by public equity float) and "seasoning" (SEC reporting history) – with the most flexibility accorded to WKSIs and the least to IPO companies – thereby allowing companies varying degrees of freedom to:
  - Avoid undue interruption of "factual" business and financial communications with the public (allowing many reporting companies to continue releasing earnings results and forecasts to the markets with heightened protection against potential "gun-jumping" risks). All eligible issuers benefit from a new, "bright-line" safe harbor (Rule 163A) that provides assurance that they can communicate more than 30 days before a registration statement is filed without fear of gun-jumping so long as they do not refer to an impending offering;
  - Communicate offering-related information to investors via a new category of "free-writing prospectuses" (and several other means), thus largely shifting the regulatory focus from the

"written" vs. "oral" character of a particular communication to its content. It is important to note, however, that many types of written communications remain subject to filing and certain other conditions tied to the size and seasoning of the issuer and the status of the offering participant. And at the end of the day, the same negligence-based liability standard under Securities Act Section 12(a)(2) applies to oral and permissible written communications deemed prospectuses unless otherwise specified by rule (e.g., an expanded Rule 134 deeming a broader array of offering-related communications not to be a "prospectus"); and

  - Expand the broker-dealer research safe harbors, under Securities Act Rules 137, 138 and 139, to apply to more issuers and more types of reports, while excluding safe-harbor coverage of the securities of penny-stock, blank-check and shell companies. In addition, the SEC made it clear that broker-dealers can rely on specified safe harbors to continue publishing research on public companies during unregistered offerings conducted under Securities Act Section 4(2) and Rule 144A, and Regulation S (offerings outside the United States).

Eliminate Physical Delivery of the Final Prospectus

- Dispense with physical delivery of the final prospectus in favor of an "access-equals-delivery" model for registered offerings by issuers of all sizes and levels of seasoning. [iii]

Enhanced Periodic Reporting Obligations

- Require disclosure in annual reports on Form 10-K under the Securities Exchange Act of 1934, as amended, of:
  - Risk factors, where deemed "appropriate" by the issuer (non-U.S. companies filing annual reports on Form 20-F are already subject to risk-factor disclosure). Material changes in these risks must be disclosed quarterly via Form 10-Q;
  - In the case of WKSIs and "accelerated filers" (which means U.S. and non-U.S. companies that have been required to file SEC reports for at least 12 months, have filed at least one annual report on Form 10-K or 20-F, and have a public equity float of at least $75 million, measured as of the end of the most recently completed second fiscal quarter), any "material" SEC staff comments issued more than 180 days before fiscal-year end that remain unresolved at the time of filing of the corresponding annual report; and
  - Self-identification of the issuer's status as a WKSI, or as a "voluntary" filer of Exchange Act reports. The latter term refers generally to those companies that are no longer subject to mandatory periodic reporting requirements, but that nevertheless continue to file such reports for a variety of reasons (e.g., public debt issuers subject to indenture covenants requiring continued SEC reporting).

Liability Implications

The SEC exercised its rulemaking power to effect what may prove, ultimately, to be major alterations in the Securities Act liability regime. It will be up to the federal courts, in the final analysis, to assess the full impact of the various regulatory changes on those offering participants particularly vulnerable to private litigation under the Securities Act – issuers, their directors and those officers who sign the registration statement (e.g., the CEO and CFO), as well as the outside auditors and the underwriters. To summarize, the SEC has adopted important regulatory modifications to the Securities Act liability framework that would:

- Cause potential "strict" liability to attach to prospectus supplements, in cases brought by private plaintiffs under Section 11 of the Securities Act alleging that a given registration statement, at the time it became effective, contained a material omission or untrue statement of material fact;
- In a shelf offering context, cause judicial determinations of Section 11 liability for issuers and underwriters to be made as of the date of a shelf takedown (essentially by making the date of first use of a takedown supplement or sale, whichever is earlier, the new "effective date" of the registration statement for issuers as well as underwriters), while continuing to tie the Section 11 liability determination for directors, officers who sign the registration statement and "experts" (including, most notably, the issuer's outside auditor), to the later of the effective date of the registration statement or the most recent annual report on Form 10-K or 20-F;
- Make companies potentially liable as "sellers" in private investor actions brought under Section 12(a)(2) (asserting claims of materially false or misleading statements in any prospectus or oral offer), despite some caselaw holding that companies not involved directly in solicitation activities cannot be sued under Section 12(a)(2) where the securities in question had been offered and sold on a firm-commitment, underwritten basis (in which the company sells the securities to the underwriters, who then resell to the investing public using the company's prospectus); and
- Limit a court's consideration, in assessing the nature and scope of a defendant "seller's" Section 12(a)(2) liability for materially false or misleading statements communicated orally or via prospectus, solely to that information deemed to be "conveyed" to an investor at or before the time of sale. In essence, this means that information set forth in the final prospectus (which as noted is no longer subject to physical delivery to investors in any event) must be disregarded by the courts in weighing a seller's "reasonable care" defense to a Section 12(a)(2) claim.

Further detail regarding these sweeping changes will be provided shortly, in the form of separate Client Alerts addressing the unique advantages and, in some cases, disadvantages, presented by the new regulatory scheme for WKSIs, other smaller and/or less seasoned companies (e.g., S-3/F-3 eligible companies, unseasoned reporting companies, debt issuers reporting solely on a "voluntary" basis under indenture covenants and IPO issuers) and underwriters. We will focus in particular on the liability implications for those shelf offering participants with a "due diligence" defense to a Section 11 claim – specifically, corporate officers and directors, and underwriters.

***

If you have any questions regarding the SEC's Securities Act reforms, please do not hesitate to contact any of the partners with whom you work at Weil Gotshal, or any of our Capital Markets partners – these are, in New York, Matt Bloch, Todd Chandler, Corey Chivers, Boris Dolgonos, David Lefkowitz, Alex Lynch, Rod Miller, and David Stone; and in London, Jeremy Dickens. Questions also can be directed to Cathy Dixon, PJ Himelfarb, and Theresa Hyatte in Washington, D.C.

---

[i] The SEC's own summary of the new and amended rules can be found in a press release available at http://www.sec.gov/news/press/2005-99.htm; *see also* Speech by SEC Staff: Opening Statement before the SEC Open Meeting, available at http://www.sec.gov/news/speech/spch062905as.htm. Our Client Alert reporting on the SEC's approval of these rules during the June 29, 2005 Open Meeting can be found on our website at http://www.weil.com.

[ii] A "WKSI" is a company that is required to file reports under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, and satisfies the following additional criteria as of the date on which its WKSI status must be determined annually (the "determination date," which generally will be the later of the time of filing of its most recent shelf registration statement, or the time of filing of its most recent annual report on Form 10-K or 20-F): (a) is eligible to make a primary offering on Form S-3 or F-3 – which means it must have been current and timely in filing all required Exchange Act reports in the past 12 months (except for certain current reports on Form 8-K); (b) as of a date within 60 days of the above-noted "determination date," has a worldwide

public equity float of $700 million or has issued, in the last three years, at least $1 billion aggregate principal amount of non-convertible debt or preferred securities in primary offerings for cash registered under the Securities Act (with the latter only being eligible to issue non-convertible debt or preferred unless it has a minimum $75 million public float); and (c) is not an "ineligible issuer," either because (i) it is a blank-check, penny-stock or similar type of SEC-prescribed "bad-boy" issuer, (ii) it has been or is subject to a Securities Act stop order or similar proceeding to halt a public offering, or (iii) the company or a subsidiary, at the time it was a subsidiary of the company, has been convicted of certain Exchange Act felonies or misdemeanors, has been found to have violated the antifraud provisions of the federal securities laws, or has been made the subject of a judicial or administrative decree or order over the past three years – including a settled claim or order – prohibiting certain conduct or activities violative of the antifraud provisions of the federal securities laws. The ineligibility of a WKSI based on antifraud settlement (whether by the company or a subsidiary at the time it was a subsidiary) will be prospective only and therefore will be triggered only by such settlements entered into after the effective date of the new rules.

[iii] Underwriters and dealers participating in underwritten IPOs will continue to have a separate obligation to deliver the preliminary prospectus, or "red herring," containing a price range. *See* Adopting Release at page 246 n. 562, citing Exchange Act Rule 15c2-8(d).