IMPACT OF THE SEC'S SECURITIES OFFERING REFORM RULES ON THE REGISTERED STRUCTURED PRODUCTS MARKET

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THE NEW SEC RULES WILL SIGNIFICANTLY AFFECT CAPITAL FORMATION IN THE U.S. AND SHAPE PUBLIC OFFERINGS.

On July 1, 2005, the SEC announced the adoption of new rules aimed at reforming the securities offering process. These rules will significantly affect capital formation in the U.S. They will also shape various features of public offerings and affect the ongoing reporting requirements for public companies.

This article describes the impact of the new rules on the market for registered structured products, i.e., "structured notes." The structured note market will be changed in four principal ways:

1. *Birth of "free writing prospectus."* The SEC will now permit issuers and underwriters to use a wide range of new materials for offering and marketing registered structured products.
2. *Changes to the shelf registration process.* The process for filing shelf registration statements that include structured products will change.
3. *Delivery of prospectuses to investors.* Actual delivery of final prospectuses will no longer be required. Issuers and underwriters of structured products will be permitted to rely on the "access equals delivery" model.
4. *Broaden the potential liabilities for issuers and underwriters.* Among other changes to the liability rules, the new rules clarify that parties may not rely on the final prospectus to cure any prior misstatements or omissions in the offering documents.

In adopting the new rules, the SEC indicated its intent to increase the amount of information available to investors regarding issuers and their securities, and to eliminate barriers to communications that have been outmoded by the Internet and other modern technologies. The new rules will become effective on December 1, 2005.

WHICH STRUCTURED PRODUCTS ARE AFFECTED?

The new rules principally affect structured products issued as securities registered with the SEC. These securities are typically issued under a shelf registration statement, using a medium-term note (MTN) program. The rules apply to both listed and unlisted products.

By contrast, a variety of platforms for issuing structured products will *not* be affected by the new rules. These include:

1. Regulation S (non-U.S.) programs.
2. Bank note programs.
3. Rule 144A offerings.
4. Equity-linked certificates of deposit.
5. Over-the-counter derivative products.

NEW CATEGORIES OF ISSUERS

To best understand the impact of the new rules, it is useful to summarize the new categorization of issuers that the SEC has created. These categories are "well-known seasoned issuers" or "WKSIs," "seasoned issuers," "unseasoned issuers," and "nonreporting issuers."

Well-Known Seasoned Issuers

The lion's share of the benefits to be enjoyed under the new rules will be obtained by WKSIs, a new category created by the SEC. Many U.S. and foreign financial institutions that are frequent issuers of registered structured products into the U.S. markets will qualify for this category. The SEC has estimated that WKSIs accounted for 96% of the total debt raised in registered offerings over the past eight years by issuers listed on major exchanges.

Under the new rules, a WKSI is a public company that:

1. Has filed its required periodic reports with the SEC for at least one year.
2. Is eligible to register primary offerings of securities on SEC "short-forms" S-3 or F-3.
3. (a) has *at least $700 million* of common equity held by non-affiliates *or* (b) *issued $1 billion* of nonconvertible securities for cash during the past three years.

The determination of whether an issuer is a WKSI will be made approximately annually. Under these criteria, most major issuers of registered structured products will fall within the WKSI category in their future offerings of these securities.

The rules contain a few nuances. For example, a wholly owned subsidiary of a public company can be a WKSI under some circumstances. Certain types of issuers cannot be WKSIs, for example, shell companies and penny stocks. These nonqualifying companies, as well as companies that have violated certain laws (described below), constitute a new category under the SEC rules called "ineligible issuers." The SEC has noted that it intends to revisit these standards in three years.

Seasoned Issuers

The second category of issuers recognized by the SEC is "seasoned issuers." These are companies that have been public for at least one year and are eligible to use From S-3 or Form F-3 to register primary offerings of their securities, but are not large enough to qualify as WKSIs.

Unseasoned Issuers and Nonreporting Issuers

Finally, the SEC rules identify two other categories of companies that are entitled to fewer benefits under the rules; they tend to be companies that are less relevant to the market for registered structured notes:

1. "Unseasoned issuers"—companies that have been public for less than a year or that otherwise do not satisfy the requirements of Form S-3 or Form F-3 for a primary offering.
2. "Nonreporting issuers"—companies that are not yet public.

FREE WRITING PROSPECTUS

The SEC's new rules will dramatically affect the landscape for creating offering materials relating to registered structured products. Historically, the ability to create marketing materials for structured products has been very limited. Under the Securities Act of 1933, and the related guidance from the SEC, all written communications prior to the final prospectus for a transaction needed to take the form of a statutory preliminary prospectus. "Written communications" included many forms of communications, including press releases, websites, e-mail messages, and other forms of "graphic communications." This resulted in a one-size-fits-all approach—the preliminary prospectus for each offering was a relatively static (and long) document, delivered in the same form to different types of investors, notwithstanding their varying levels of sophistication. Issuers and underwriters had very few options for creating marketing materials for their registered structured products.

WITH THE USE OF THE FREE WRITING PROSPECTUSES, ISSUERS AND UNDERWRITERS WILL GAIN THE ABILITY TO USE ADDITIONAL OFFERING MATERIALS THAT MIGHT PREVIOUSLY HAVE BEEN CONSIDERED IMPROPER.

Permitted Free Writing Prospectuses

The SEC's new rules create a new category of document called a "free writing prospectus," a written communication deemed to be an offer to sell a security, but that does not include all the required disclosures of a traditional preliminary prospectus. As a result, issuers and underwriters will gain the ability to use additional offering materials that might previously have been considered improper. Examples of possible permitted free writing prospectuses that may be distributed to investors include:

1. Summary term sheets for a transaction.
2. Summary product descriptions—glossy pamphlets to describe a product, including customized materials for different types of investors with different levels of knowledge or investment goals.
3. Dedicated web pages to describe products.
4. Distributions of CD-ROMS describing products.

These materials will not need to be attached to a preliminary or final prospectus, as is the current practice for some forms of supplemental sales material used today.

The free writing prospectus can have more or less information than a statutory prospectus. However, the information in a free writing prospectus cannot *conflict* with the information in the statutory prospectus.[1]

When Can a Free Writing Prospectus Be Used?

WKSIs may use free writing prospectuses even before filing a registration statement, provided that they include a special legend on the document. In this situation, the free writing prospectus would need to be filed with the SEC after the registration statement is filed. When a WKSI or another seasoned issuer uses a free writing prospectus, it does not need to deliver beforehand a statutory prospectus to the investor; instead, the free writing prospectus must simply contain a legend indicating where the investor may access the statutory prospectus, or providing a hyperlink to the statutory prospectus.[2] The legend must contain a toll-free telephone number, and may contain an e-mail address, by which the statutory prospectus may be requested.[3]

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1 Underwriters will need to be mindful of the NASD regulations that relate to these marketing materials. In its Notice to Members 05-09 (September 2005), the NASD reminded underwriters that marketing materials for structured products must present a fair and balanced picture of both the risks and the benefits. The NASD observed that existing supplemental sales materials were often insufficient in this regard.

2 In contrast, an unseasoned issuer must deliver a statutory prospectus to an investor prior to or with a free writing prospectus.

3 The new rules provide issuers and underwriters with an opportunity to cure an unintentional or immaterial failure to include the required legend.

Who May Not Use a Free writing Prospectus?

Several issuers, called "ineligible issuers," will not be permitted to use free writing prospectuses under the new rules:

1. Issuers that have violated the securities laws.
2. Issuers that are not current in their periodic Exchange Act filings (however, an issuer may use a free writing prospectus if one or more of the reports was filed *late*).
3. Issuers that have filed for bankruptcy, or have been insolvent, during the last three years.
4. Issuers (including subsidiaries) that have entered into a settlement with a government agency involving allegations of violations of the securities laws.[4]

On a showing of "good cause," the SEC may determine that a company otherwise ineligible should not be considered an ineligible issuer. However, the standards for making this determination have not yet been publicized.

Filing the Free Writing Prospectus

A variety of free writing prospectuses, which must be filed with the SEC, will become publicly available on the Internet at the SEC's Edgar website (www.sec.gov/edgar.shtml):

1. Free writing prospectuses prepared or used by the issuer of the securities, or on its behalf.
2. Free writing prospectuses used by an underwriter that contain material information about the issuer or its securities that has been provided by the issuer and that has not been already filed.
3. Free writing prospectuses prepared by an underwriter and distributed in a manner designed to lead to their "broad unrestricted dissemination."
4. Free writing prospectuses that contain a description of the final terms.

As a result of (3) above, underwriters and selling agents will not be required to file most of the free writing prospectuses that they prepare. This will help ensure that documents such as preliminary term sheets and descriptions of novel new products need not enter the public domain until used in connection with an actual transaction. Free writing prospectuses not subject to the filing requirements will need to be retained for three years from the date of the offering.

THE AUTOMATICALLY EFFECTIVE SHELF REGISTRATION STATEMENTS WILL ELIMINATE THE POTENTIAL DELAYS THAT COULD RESULT FROM AN SEC REVIEW OF A FILING, POTENTIALLY ENABLING SOME ISSUERS TO GO TO MARKET MORE QUICKLY.

CHANGES TO THE SHELF REGISTRATION PROCESS

The new rules will affect how issuers register structured notes on a shelf registration statement.

Size of Shelf and Term of Effectiveness

The new rules eliminate two existing requirements:

1. That a registration statement be limited in size to the amount of securities that an issuer can offer over a two-year period.
2. That a registration statement be effective for a virtually unlimited period.

Instead, shelf registration statements will be effective for a maximum period of three years and will enable issuers to register an unlimited amount of securities. If a new registration statement is filed within three years of the original effective date of the old registration statement, the issuer may continue to offer and sell securities from the old registration statement for up to six months until the new registration statement is declared effective. These provisions will help ensure that issuers are not blocked out of the market as a result of the pending expiration date of a registration statement.

Automatically Effective Shelf Registrations

WKSIs will obtain an additional benefit—the shelf registration statements that they file will be automatically effective. This will eliminate the potential delays that could result from an SEC review of a filing, potentially enabling some issuers to go to market more quickly. WKSIs may also add (1) new subsidiaries to an effective shelf registration statement by filing a post-effective amendment that will immediately become effective on filing, and (2) new types of securities, which might not have been con-

[4] Ineligibility of an issuer based on a settlement will be *prospective* only and will arise after the effective date, December 1, 2005. This provision, which is designed to enable companies entering into such a settlement in the future to negotiate a waiver of the ineligible issuer disqualifications, was requested by many parties that commented on the initial rule proposal. As initially proposed, the rules could be deemed to bar issuers from using free writing prospectuses if they had an existing settlement agreement with the SEC.

templated at the time of the initial filing, to an effective shelf registration statement.

Pay-as-You-Go Registration Fees

WKSIs will enjoy "pay-as-you-go registration fees." That is, the required SEC registration fee may be paid at the time of each takedown, instead of paying a lump sum in advance. This may prove useful when the issuer is uncertain at the time of the initial filing about the frequency of issuances or the size of offerings. Frequent issuers of structured notes will need to update their "transaction checklists" to ensure that the fee is timely paid for each takedown. The pay-as-you-go system will be optional; issuers will also have the ability to pay the registration fee at the time of the initial filing, as is the current practice.

PRINTING FINAL PROSPECTUSES

Under the new rules, issuers of registered structured products will no longer be required to actually deliver final prospectuses to purchasers. Instead, issuers and underwriters will be permitted to rely on the issuer's electronic filing of the prospectus with the SEC. When sending their confirmations, the underwriters can notify the investors that the related sale was made under a registration statement and that the final prospectus is publicly available on-line. For issuers that have an affiliated underwriter making a market in their securities, the new rules also eliminate the requirement of printing and delivering "market-making prospectuses." The rules also include a provision that allows the issuer to cure an unintentional failure to file if it has made a good faith effort to comply.

The new provisions will reduce the administrative costs to issuers and underwriters of printing and delivering prospectuses. They may be particularly helpful for certain low-margin products, or products with a large number of retail purchasers. Some administrative expenses may also be saved by reducing the need to focus on secondary prospectus issues, such as formatting, appearance, and paper quality.

REVISIONS TO TIMING FOR LIABILITY UNDER THE SECURITIES LAWS

A full treatment of the interplay between section 12(a) and section 17(a) under the Securities Act of 1933, and how their different timing implications apply to issuers and underwriters under the old and new rules, is beyond the scope of this article.[5] However, the new rules codify the following interpretation of the SEC as to these liability rules: information conveyed to an investor only after it enters into a contract for the purchase of securities will not be considered in determining liability for a materially misleading misstatement or omission under these two sections. Instead, the only information that will be considered is the information conveyed orally or in writing *at or before* the time of sale.

What are the results of this change? It will not be sufficient to deliver an accurate final prospectus that corrects any prior misstatements or omissions after the pricing of a security but before the closing. Rather, it will be important to ensure that investors have received the relevant information before pricing and confirming orders. This change in the timing of liability potentially increases the importance of free writing prospectuses.

When the terms of a registered structured product change materially after the distribution of a preliminary prospectus, but before the pricing, or if the working group determines that the preliminary prospectus was somehow inaccurate, a free writing prospectus may be used to update the investors on the new terms or information. Alternatively, underwriters may rely on the long-standing practice of phoning investors to ensure that the relevant new information has been properly transmitted before the sale.

IF THE SEC'S RULES ARE SUCCESSFULLY IMPLEMENTED, ISSUERS OF REGISTERED STRUCTURED PRODUCTS WILL ENJOY ENHANCED FLEXIBILITY IN THEIR REGISTRATION, MARKETING, AND OFFERING PROCESSES.

CONCLUSION

The new SEC rules will become effective on December 1, 2005. Many issuers and underwriters are preparing for the new regulatory landscape—updating their securities documents, contemplating new types of disclosure documents, and preparing for the possibility of enhanced marketing opportunities for their registered structured products. If the SEC's rules are successfully implemented, issuers of registered structured products will enjoy enhanced flexibility in their registration, marketing, and offering processes. Investors are also likely to benefit, by having more customized, user-friendly, and informative information available to them before they make an investment decision.

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[5] For example, the landscape for securities litigation will be affected because each new shelf takedown will be regarded as creating a new "effective date" for purposes of determining the potential liability of issuers and underwriters. This represents an expansion of the use of section 11 of the Securities Act of 1933 as a source of potential liability in securities cases.