

OUTSIDE COUNSEL

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The SEC's Securities Offering Reform and Small Public Companies

Following the adoption of the much-publicized Sarbanes-Oxley Act of 2002 (also known as SOX) and its subsequent SEC rulemaking and associated compliance costs, smaller companies have been left wondering whether things might get worse.

On June 29, 2005, the Securities and Exchange Commission (SEC) adopted the most significant Securities Act reforms in decades.

What do these reforms mean to smaller public companies? Unlike the increased compliance costs of SOX, the new rules should not increase the cost of conducting a registered offering. Rather, the reforms are aimed at liberalizing the process of registration and easing various restrictions on communications during the offering period. Unfortunately, a significant part of these reforms are aimed at a specific class of large public companies, leaving many smaller companies without the benefits of the new rules.

The new SEC rules, which were effective Dec. 1, 2005, primarily relate to two aspects of registered offerings: (i) issuer communications before and during the registration process, and (ii) shelf registrations. The extent to which a company may benefit from the new rules depends for the most part on which of the following four newly created categories of issuers it falls into:

- (i) "Well-known seasoned issuers," which are reporting issuers that have a nonaffiliate common equity market value of at least \$700 million, or which have offered at least \$1 billion aggregate principal amount of nonconvertible (noncommon) securities in primary registered offerings for cash



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(not exchange) within the prior three years;

(ii) "Seasoned issuers," which are reporting issuers that have a nonaffiliate common equity market value of at least \$75 million (i.e., they are eligible to use the Form S-3 registration statement for primary securities offerings);

(iii) "Unseasoned issuers," which are reporting issuers who do not have a nonaffiliate common equity market value of at least \$75 million; or

(iv) "Nonreporting issuers," which are issuers that are private companies or file Exchange Act reports voluntarily (i.e., not registered under the Exchange Act).

Automatic Shelf Registration

• **Automatic Shelf Registration for "Well-Known Seasoned Issuers."** The most far-reaching aspect of the SEC's reforms relate to the creation of a new "automatic shelf registration" form. This form will allow a "well-known seasoned issuer" to file a short-form shelf registration statement which will become effective automatically upon filing.

Issuers using this form will be able to simply designate the class of securities registered, while omitting information relating to the amount of securities being registered, as well as the names of any selling stockholders and the proposed plan of distribution. All of the omitted information can then be added to the prospectus before an applicable "takedown" through a

post-effective amendment, a prospectus supplement, or by incorporation by reference to the company's Exchange Act reports.

As the director of the SEC's Division of Corporation Finance indicated in a recent Practising Law Institute (PLI) conference, this is as close to an

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"issuer registration" concept as the SEC could get without completely rewriting the registration rules. Even the applicable filing fees may be deferred until a take-down through a newly instituted "pay-as-you-go" system. All of this translates into instant access to capital markets through a registered offering.

Liberalization

• **Liberalization of Shelf-Registration Practices for Seasoned Issuers.** While the automatic shelf registration is only available to "well-known seasoned issuers," at least seasoned issuers can take advantage of most of the SEC's reforms in the area of continuous or delayed offerings.

These rule changes (which were in large part a codification of current practices) also allow for the omission of certain information at the time of filing of an S-3 shelf registration statement (also known as a "base" prospectus), to be supplied post-filing through a post-effective amendment, a prospectus supplement, or by incorporation by reference to the company's Exchange Act reports.

Additionally, for seasoned issuers, the SEC has eliminated the limits on the amount of securities to be registered in Rule 415 offerings as well as the requirement to use an underwriter in connection with "at-the-market" offerings, and has allowed immediate takedowns for primary shelf offerings.

The main restriction on these base shelf registrations (including the automatic shelf) is that the registration statement itself may only be used for three years from the date it is filed. Further, for registration statements covering the resale of privately placed securities by selling stockholders, the amount of information that may be omitted from the "base" prospectus is limited.

Smaller public companies may be asking why the new shelf-registration rules and forms were not made available to them. The SEC distinguished "well-known seasoned issuers" because these are the type of companies that are widely followed by the investing public. As a result of the interest in such companies, the information disseminated by them is subject to more scrutiny by sophisticated institutional and retail investors, therefore mitigating the need for SEC involvement.

Conversely, smaller companies usually do not have the kind of following that might alleviate the need for the SEC to review their disclosures more carefully. Also, the SEC staff has stated that the bulk of the SEC's enforcement docket involves smaller companies, which the SEC indicates are not ready to be given the latitude of the new liberalized registration rules. Interestingly, however, it was the large corporate scandals such as those involving Enron and WorldCom (who at the time would have fit the category of a "well-known seasoned issuer") that caused the most significant damage in terms of investor losses and spurred the adoption of SOX.

'Free Writing Prospectuses'

• **Communications During the Registration Process: "Free Writing Prospectuses."** In a measure designed to encourage communications with investors during registration, the SEC has provided all sizes of issuers and other offering participants (such as underwriters) the ability to use a "free writing prospectus," which is "a written communication that constitutes an offer to sell or a solicitation of an offer to buy securities that are or will be the subject of a registration statement," but which is something less than a prospectus (i.e., does not meet all of the requirements of a §10(a) prospectus). They may not, however, be misleading.

The key to free writing prospectuses is that they are not subject to the same liability as statements made in a statutory prospectus, i.e., §11 liability. In general, free writing prospectuses must be filed with the SEC and contain certain legends as a condition to their use. For "well-known seasoned issuers,"

free writing prospectuses can be used at any time. For all other issuers, a free writing prospectus may only be used after the applicable registration statement containing a §10 statutory prospectus has been filed, and, in the case of unseasoned and nonreporting issuers, the free writing prospectus must be preceded or accompanied by the most current statutory prospectus (which, in the case of an electronic communication, can be achieved by the inclusion of a hyperlink to the registration statement).

Certain media communications or broadcasts (in the case of unseasoned or nonreporting issuers, those not prepared or paid for by the company or the offering participants), such as the Google pre-IPO Playboy interview, will be considered "free writing prospectuses" and permitted during the registration process (subject to complying with the free writing prospectus requirements). The advent of free writing prospectuses should allow issuers and

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underwriters to communicate with investors in writing about an offering without the burden of meeting the detailed prospectus requirements.

Gun-Jumping Rules

• **Communications During the Registration Process: Gun-Jumping Rules and Road Shows.** There is some more good news for smaller issuers (even nonseasoned issuers) involved in registered offerings.

In an effort to ease the restrictions on information released by issuers during the registration process, the SEC revamped the "gun jumping" rules for all issuers (to varying degrees). Seasoned and unseasoned issuers (unless they were a "blank check," "shell" or "penny stock" issuer within the past three years) will be expressly allowed to continue publishing regularly released factual business information and forward-looking information (such as earning forecasts) without casting doubt on whether an ongoing or planned registration will be negatively affected (well-known seasoned issuers will have virtually no restrictions on communications while in registration, while nonreporting issuers may not publish forward-looking information and may only publish regularly released factual business information for use by persons other than in their capacity as investors or potential investors).

In addition, any communication made more than 30 days prior to the filing of a registration statement and which does not make reference to an offering will fall within a safe harbor from the gun-jumping prohibitions, as long as the issuer takes reasonable steps to prevent redistribution of such communications during the 30-day period preceding the offering.

The SEC also clarified its positions on road shows and other

communications during the registration process, all of which will provide greater certainty to all issuers during registration.

• **Additional Exchange Act Disclosures.** Some additional requirements were imposed for regular periodic reports. The SEC has mandated that all 10-Ks (but not 10-KSBs) must now include risk factors "where appropriate" (and updated quarterly, if necessary), and "accelerated" filers (generally seasoned and "well-known seasoned issuers") must disclose any material SEC comments which remain unresolved for more than 180 days.

Prospectus Delivery

The SEC also updated its rules (for all issuers) with respect to prospectus delivery requirements. In most cases, physical delivery of a prospectus will no longer be required as long as the final prospectus is readily available by electronic means, is part of a registration statement filed within the SEC before the sale confirmation, and the purchaser is notified as to how to access the prospectus. This is known as the "access equals delivery" model of prospectus delivery. Finally, the new rules will permit reporting companies filing a registration statement on Form S-1 to incorporate by reference past Exchange Act filings (but not future filings), which will simplify the registration process for companies who are not eligible to use a Form S-3 for primary offerings.

Conclusion

While the new rules relating to communications during registration benefit for all types of issuers (with the exception of the blank check, shell and penny stock companies), the main beneficiaries of the new shelf-registration rules will be large public companies. For issuers who do not fall into the "well-known seasoned issuer" category, the quickest access to capital markets may remain through private placements followed by resale registrations (also known as PIPES).

Even though the SEC justified the easing of securities offering requirements mostly due to the increased disclosure requirements imposed by SOX—which for the most part apply to all reporting issuers equally, large and small—the SEC explained the favorable treatment of larger entities in terms of the level of scrutiny they face from sophisticated investors, and consequently the lower concern about investor protection.

So while smaller companies have had to improve their Exchange Act disclosures almost as much as "well-known seasoned issuers," as well as incur the significant costs of §404 of SOX (internal controls compliance), this is not enough in the SEC's view to warrant instant access to capital markets through registered offerings.

The SEC did recognize in its adopting release that for smaller issuers the new registration rules may not be as meaningful, but indicated that it "will consider the available information to determine whether greater flexibility [for smaller entities] is warranted, consistent with investor protections. In this regard, [the SEC has] established an Advisory Committee on Smaller Public Companies to examine these and other related issues." Whether this will translate into any meaningful reforms for smaller issuers remains to be seen.