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Will Free Writing Prospectuses Be Used?

The SEC recently adopted reforms creating the free writing prospectus— a new protocol for offering related communications outside of a registration statement. The free writing prospectus offers intriguing potential for communications, but also raises lingering concerns about liability. Given this tension, will anyone use the free writing prospectus?

by David B.H. Martin and Keir D. Gumbs

This winter, securities offering reforms will go into effect that, among other things, could radically change the way in which issuers and other offering participants communicate in public securities offerings.[1] The reforms as a whole address three principal areas: (1) communications during the offering process, (2) offering procedures and mechanics, and (3) liability provisions for offering-related communications. As part of the first in that triad, it is the newly minted "free writing prospectus" that has garnered much attention. This new protocol, the SEC hopes, will open the door to greater and freer communications by issuers and other offering participants during the offering process.

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Despite open support of these reforms, however, there have been some notes of caution. Some observers, although welcoming of the reforms, also are reserved as to their utility. New freedoms are coupled with opportunities to test new liabilities, with the most prominent example being the free writing prospectus. While some look eagerly to the communications pleasures the free writing prospectus could offer, others question liabilities that may attend its use. In view of this uncertainty, there is still reason to doubt whether the free writing prospectus has opened the door to a new world of communication through which many will walk.

Background

Since the enactment of the Securities Act of 1933, federal securities law has drawn a distinction between written and oral communications in public securities offerings. Section 5(c) of the Securities Act provides that no offers, written or oral, may be made before the filing of a registration statement with the SEC. Once a registration statement is filed with the SEC, Section 5(b) permits oral offers but prohibits any other offers made by means of a prospectus, other than a prospectus that complies with Section 10 of the Securities Act. For shorthand, the SEC generally refers to such a prospectus as a statutory prospectus.[2]

As used in Section 5, offer and prospectus carry broad meanings. An "offer," under the Securities Act Section 2(a)(3), includes "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." Securities Act Section 2(a)(10) defines the term "prospectus" to cover

"any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale." By operation of these definitions, issuers and offering participants are prohibited from making any offers by means of a written communication outside of the statutory prospectus before a registration statement is declared effective. If an issuer violates Section 5 during these periods by, for example, using a prospectus that does not include all the information required by a statutory prospectus, the violation of Section 5 is commonly referred to as "gun-jumping."

The parameters of the broad definitions of the terms offer and prospectus are more easily summarized than is their operation. The unequivocal prohibition against offers by prospectus outside the registration statement poses a significant challenge for issuers that are in registration. For more than a decade, these challenges have driven calls for changes, particularly in response to the expansion and democratization of the capital markets, as well as, the relentless march of technology. In a world of IRAs and 401(k)s, Web sites, and emails, there has been a demand from issuers for increased speed in capital markets transactions and a demand from investors for more direct and open access to information.

Defining a Free Writing Prospectus

To address these calls for modernization of public offering rules, the SEC has now adopted a comprehensive package of new provisions relating to communications by issuers and offering participants during registered securities offerings. Its keystone is the free writing prospectus.[3]

The free writing prospectus is implemented from a regulatory standpoint through a series of rules (Rules 163, 164, 405, and 433) that create a safe harbor system under Section 5 of the Securities Act designed to let issuers and offering participants communicate more freely in registered offerings. A "free writing prospectus" is any written communication used in the offer or sale of securities covered by a registration statement that is made outside of that registration statement, or more precisely, by means other than a prospectus satisfying the requirements of Section 10(a) of the Securities Act or SEC rules permitting the use of preliminary or summary prospectuses. Little is ever truly free, however, and, to be expected, there are conditions to the use of a free writing prospectus. Those conditions are set forth in new Rule 433.[4]

Conditions to Use

Filing requirement. As a general matter, Rule 433(d) requires that issuers and other offering participants file free writing prospectuses no later than the date of first use. The rule draws a distinction between the issuer and other offering participants participating in the offer and sale of the securities (for instance, underwriters). An issuer is required to file with the SEC any free writing prospectus that it prepared, as well as issuer information used in a free writing prospectus of another offering participant. Any other offering participant, such as the underwriter, is only required to file a free writing prospectus that it distributes in a manner reasonably designed to lead to its broad unrestricted dissemination.[5] These filing conditions do not apply in three situations: (1) if the free writing prospectus does not contain substantive differences from a free writing prospectus previously filed with the SEC; (2) if the issuer information in the free writing prospectus was previously filed; or (3) if the free writing prospectus contains only a description of the terms of the issuer's securities offering but does not reflect the final terms. The new rules include a provision allowing unintentional failures to file so long as a reasonable, good faith effort was made. In such cases, the materials must be filed as soon as practicable.[6]

Legend requirement. Under Rule 433(c), a free writing prospectus must include a legend. The legend need not be issuer specific, but must indicate where a prospectus is available for the offering to which the communication relates and recommend that investors read the prospectus and Exchange Act documents incorporated by reference, both of which are available through the SEC's Web site.

Record retention requirement. Rule 433(g) requires that an issuer or other offering participant retain a free writing prospectus that it did not file with the SEC for three years from the initial bona fide offering of the securities to which the free writing prospectus relates.

Availability or delivery of a statutory prospectus requirement. Under Rule 433(b), an unseasoned or

non-reporting issuer must accompany or precede each free writing prospectus with the most recent statutory prospectus (unless there have been no changes to a previously provided prospectus). A well-known seasoned issuer or a seasoned issuer, by contrast, is only required to have filed a statutory prospectus with the SEC. Further, a well-known seasoned issuer may use a free writing prospectus prior to the filing of its registration statement pursuant to Rule 163.

Other Aspects of the Free Writing Prospectus

Media free writing prospectuses. Under the new free writing prospectus rules, issuers and offering participants may communicate more freely with members of the media. Prior to these changes, any communication by an issuer or underwriter with the media during an offering has posed serious issues. Such a communication, if reflected in a publication, risked being viewed as a form of written communication, thereby violating the gun-jumping provisions of Section 5. Under the new rules, however, communications with the media will be permissible free writing prospectuses if made in compliance with the four conditions previously outlined.[7]

Recognizing the challenge of these conditions in the context of communicating with broadcast or print media, the SEC further eased regulatory friction with media communications by relaxing the conditions for certain free writing prospectuses published by the media. Such communications are subject only to legend, retention, and modified filing requirements, and not the prospectus delivery requirement, of other free writing prospectuses. To qualify for this relaxed treatment, the issuer or the offering participant that is responsible for the media free writing prospectus must not have provided consideration for the preparation or distribution of such prospectus. Further, the issuer or offering participant must file the media free writing prospectus or the information underlying the media free writing prospectus within four days of becoming aware of its dissemination, publication or broadcast. If, however, an issuer or offering participant provides consideration for the communication or fails to file the communication within four days of becoming aware of its dissemination, the media publication is considered a regular free writing prospectus that must comply with all of the rules noted.[8]

Electronic road shows. Under the new rules, electronic road shows are written offers and, unless included in a prospectus filed as part of a registration statement, would be free writing prospectuses.[9] Electronic road shows for initial public offerings of common equity securities or convertible equity securities are subject to all of the rules applicable to other free writing prospectuses. Such road shows must include the legend prescribed by Rule 433 and must be preceded or accompanied by a statutory prospectus, *i.e.*, with a price range. As an accommodation to such offerings, an issuer is afforded the choice between making a bona fide version of the road show publicly available, for instance on a Web site, or filing a *bona fide* version of the road show with the SEC. As with other free writing prospectuses, if an issuer has filed at least one *bona fide* version of the road show with the SEC it must retain, but need not file, subsequent road shows. Electronic road shows that do not involve initial public offerings of equity securities or convertible equity securities are not subject to the filing condition imposed on other free writing prospectuses. Instead, such communications need only include the required legend, be retained for three years and be preceded or be accompanied by the statutory prospectus, which could be accomplished, through the inclusion of a hyperlink.

Liability for free writing prospectuses. Free writing prospectuses are subject to liability under Section 12(a)(2) of the Securities Act as well as under the general anti-fraud provisions of the Securities Act and the Exchange Act. Free writing prospectuses are not, however, considered part of the registration statement and are not therefore subject to Section 11 of the Securities Act.

Under Rule 159A, an issuer is responsible for any free writing prospectus that is "prepared by or on behalf of, or used or referred to by, the issuer."[10] In contrast, under Rule 159A, an offering participant is responsible for a free writing prospectus if:

- Used or referred to the free writing prospectus in offering or selling the securities to the purchaser,
- Offered or sold the securities and participated in the planning of the use of the free writing prospectus by one or more other participants that used the free writing prospectus, or

- Was required to file the free writing prospectus under Rule 433 (*e.g.*, because the offering participant was broadly distributing the free writing prospectus).

All communications that are not oral are "written." Counterbalancing the liberalization of the communications rules with the advent of the free writing prospectus, the SEC has adopted new definitions for the terms graphic communication and written communication in Securities Act Rule 405. The term "graphic communication" is expanded to include "all forms of electronic media," such as "audiotapes, videotapes, facsimiles, CD-ROM, electronic mail, Web sites, substantially similar messages widely distributed (rather than individually distributed) on telephone answering or voice mail systems, computers, computer networks and other forms of computer data compilation." The term "written communication," a new definition, covers "any communication that is written, printed, broadcast by radio or television, or a graphic communication." As a result of these definitions, virtually *any* communication that is not oral is deemed to be written and therefore subject to the restrictions under Section 5 of the Securities Act. This is an important component of a regulatory mix that now gives issuers and offering participants increased latitude to communicate before, during and after the registration process.

Liability Issues

Although the free writing prospectus should, on its face, present new flexibility in offering communications, there is uncertainty as to the extent to which issuers and other offering participants will embrace the new protocol because of liability concerns. The two most significant liability issues raised by the free writing prospectus rules are (1) cross-liability and (2) what constitutes an issuer free writing prospectus.

Cross-Liability Issues

New Rule 159A provides that an offering participant is responsible for any free writing prospectus that the offering participant "used or referred to." It goes on to provide that a participant is liable for any free writing prospectus for which it participated "in the planning of the use of the free writing prospectus." It is an open question under Rule 159A and other free writing prospectus rules what conduct subjects an offering participant to liability for information in another's free writing prospectus.

For example, does the circulation of a draft free writing prospectus constitute "planning of the use of the free writing prospectus"? Does liability attach for all syndicate members that comment on the draft? Are members that did not review the document subject to Section 12(a)(2) liability for the contents of the free writing prospectus?

The SEC may have intended these provisions to address situations in which syndicate members attempt to avoid liability for a free writing prospectus by having another member distribute the free writing prospectus on their behalf. In the absence of further interpretive guidance, however, it is likely that issuers and other offering participants may not rely on these provisions without protection in indemnification or procedural agreements.[11] (Editor's Note: For further discussion of possible changes to underwriting agreements see Tsacoumis article in this issue of *INSIGHTS*.)

Based on concerns about cross-liability, issuers and underwriters may use the new rules sparingly and under careful controls. Offering syndicate members may wish to negotiate underwriting agreements that prescribe specific rules of conduct for the use of free writing prospectuses by syndicate members. Further, because emails and other forms of electronic communication are likely to be deemed prospectuses under the definitions of graphic and written communications, underwriting agreements may become more detailed in terms of communications made by syndicate members, including specificity as to information that may be distributed via email.

For instance, there likely will be provisions covering approval procedures for issuer or underwriter free writing prospectuses, as well as provisions that specify which syndicate members may use free writing prospectuses. Lead underwriters may require pre-approval of free writing prospectuses to be used by syndicate members. It is also possible that issuers and underwriters will negotiate representations and warranties about whether the issuer or other offering participants were involved in the publication of free writing prospectuses by other parties.[12]

Determining What Constitutes an Issuer Free Writing Prospectus

In addition to cross liability, another significant question raised by the free writing prospectus rules is when is a free writing prospectus deemed to be an *issuer* free writing prospectus. An issuer is responsible for filing, and is responsible for any free writing prospectus that is prepared by or on behalf of, or used or referred to by, the issuer. Because issuers may be liable for such prospectuses, issuers may require pre-clearance of all free writing prospectuses used by anyone in the syndicate. This, of course, presents a dilemma: The issuer's consultation or approval of an offering participant free writing prospectus may result in the prospectus being deemed to be an issuer free writing prospectus, subjecting the prospectus to filing obligations and subjecting the issuer to Section 12(a)(2) liability for the prospectus. Examples of the kinds of conduct that might transform a free writing prospectus of another offering participant into an issuer free writing prospectus include:

- Issuer approval of drafts of an offering participant free writing prospectus,
- Issuer distribution of an offering participant free writing prospectus (*i.e.*, an issuer's use of offering participant free writing prospectuses that are used in road shows), and
- Preparation of a free writing prospectus based on information given by the issuer.

To manage the use of free writing prospectuses and to minimize the risk of an offering participant free writing prospectus being deemed to be an issuer free writing prospectus, issuers may take one of two approaches. The first approach may be to prohibit the use of any free writing prospectus other than an issuer free writing prospectus. This approach addresses concerns raised by unmonitored free writing prospectuses.

The second approach is more relaxed; an issuer may wish to delegate responsibility for approving offering participant free writing prospectuses to the lead underwriter. Although offering participants would still have to ensure that the offering participant free writing prospectus does not contain issuer information, this second approach at least ensures that the issuer is not liable for such communications. Underwriters, however, particularly the underwriters to whom such authority will be delegated, may thereby assume liability for the free writing prospectus so approved on the grounds that they "participated in the planning of the use of the free writing prospectus by one or more other participants that used the free writing prospectus."

Probable Uses of Free Writing Prospectuses

Liability issues notwithstanding, there are a number of probable areas of first adoption for the free writing prospectus.

Shelf Offerings

We expect that issuers and underwriters will use free writing prospectuses in the context of newly enhanced shelf offering procedures.[13] In response to Section 5 concerns, it has become standard practice for issuers and underwriters to convey the terms of proposed shelf takedowns orally to investors, while final offering information is reduced to writing in a prospectus supplement only after the sale has taken place.

Now, with the introduction of the free writing prospectus, issuers may exchange a free writing prospectus that contains preliminary terms of the offering without violating the gun-jumping rules. Such communications must, of course, comply with the legend and retention requirements applicable to other free writing prospectuses. Under new Rule 433(d)(5)(i), however, free writing prospectuses that include only preliminary information are not required to be filed. Issuers must file the free writing prospectus that contains the final terms of the securities in the offering within two days after the later of the date such terms became final for all classes of the offering or the date of first use.

Information Conveyed at the Time of Sale

Issuers and underwriters may use free writing prospectuses to ensure that material information is conveyed "at the time of sale" for the purposes of new Rule 159 of the Securities Act. In new Rule 159, the SEC codified an existing interpretive position to the effect that information conveyed after the time of sale should not be taken into account for the purposes

of assessing whether information conveyed at the time of sale is materially misleading. Under this rule, information conveyed to an investor after the investor commits to buy the security cannot be used to defend an antifraud claim under Section 12(a)(2) or 17(a)(2).[14] This position has significant implications for shelf offerings when the final prospectus is not prepared until after the contract for sale has been formed. Now, based on the SEC's interpretive position and Rule 159, it will be clear that information contained in a prospectus or prospectus supplement that is filed after a contract of sale is formed will not be deemed part of the information available to investors at the time of the contract of sale. Accordingly, issuers and underwriters will likely structure shelf offerings so as to ensure that the terms of the offered securities and other material information relating to the issuer and the transaction have been conveyed to the investor at the time of sale. We expect that a free writing prospectus (most likely in the form of a term sheet) will be used for this purpose.

Communications That Might Otherwise Be Deemed to Be Gun-Jumping

Issuers and other offering participants also may rely on the free writing prospectus rules to avoid risks of gun-jumping. Under current practices, an issuer or offering participant may face significant consequences for gun-jumping.[15] The new free writing prospectus rules present a means by which an issuer or offering participant may mitigate or avoid these consequences altogether. When issuers or other offering participants become aware of a communication outside the registration statement that may be deemed to be an offer, the issuer and offering participants may reason that the communication, as a written offer, is a free writing prospectus.

In order for such a communication to satisfy the requirements for a free writing prospectus, the issuer or other offering participant must file the communication as a free writing prospectus as soon as practicable and retransmit the communication, with a required legend, by substantially the same means and to substantially the same investors.[16] Presumably this means that a free writing prospectus that is transmitted through a radio or television broadcast would have to be transmitted through the same means. It is not clear how an issuer could accomplish similar re-transmission for communications made through magazine interviews and similar media. This is likely to be fertile ground for guidance and interpretation. [17]

Communications with the Media

Many of the widely publicized cases of gun-jumping by issuers that are conducting registered offerings have involved situations in which a member of management communicated with members of the press. To the extent that such communications take place after the effectiveness of the new securities offering rules, it is likely that issuers and other offering participants will seek to treat them as media free writing prospectuses.

Electronic Road Shows

Free writing prospectuses are likely to be used in connection with electronic road shows. Since 1997, electronic road shows have been governed by a series of no-action letters issued by the staff of the Division of Corporation Finance.[18] Those letters placed numerous conditions on the operators of the road shows, including restrictions as to the audience, manner of publication, and how often the road shows could be seen. When the new rules become effective, the SEC will rescind the positions expressed by the staff in their letters. This liberalization is not without cost. Because an electronic road show involves an "offer" under Section 5 of the Securities Act and would be deemed to be a written communication, an electronic road show must be filed as a part of the registration statement or conducted as a free writing prospectus. As a result, an issuer or underwriter that elects to conduct an electronic road show will likely treat it as a free writing prospectus.

Conclusion

New SEC rules permitting the use of free writing prospectuses should allow issuers and other offering participants to communicate more freely while in registration. The rules have engendered enough uncertainty, particularly in terms of potential liability under Section 12(a)(2) of the Securities Act, to cause caution in the near term. Further consideration and SEC interpretive gloss will need to attend full realization of the potential in this area. Moreover, industry participants will want to develop standard practices regarding underwriting agreements or other offering procedures.

In the meantime, the use of free writing prospectuses will be limited to situations in which the additional liabilities are marginal and the new rules offer a clear advantage over current practices. Shelf offerings, communications made to ensure that the information is conveyed at the time of sale, communications that would be deemed to be gun-jumping, communications with the media, and electronic road shows are just a few examples of instances in which issuers and other offering participants may conclude that such benefits outweigh burdens.

NOTES

1. *See* Securities Offering Reform, Release No. 33-8591 (Jul. 19, 2005) (Offering Reform Release). All references to page numbers in the Offering Reform Release refer to the page numbers on the PDF version of the release that is available on the SEC's Web site at *http://sec.gov/rules/final/33-8591.pdf*.

2. Although there is no formal definition of "statutory prospectus," the term is generally understood to refer to a prospectus that complies with Section 10 of the Securities Act, which, in the context of an initial public offering, requires a bona fide price range.

3. Other elements of the communications rules reforms include expansions to or additions of safe harbors for communications unrelated to offerings or in research reports. Many of the reforms are best understood as they apply to various categories of issuer. The reforms create two new categories of issuer: (1) the well-known seasoned issuer and (2) the ineligible issuer. These are layered onto three existing categories, which the SEC calls (1) seasoned issuers, (2) unseasoned issuers, and (3) non-reporting issuers. *See* Rule 405.

4. A free writing prospectus may not contain information that conflicts with information in the prospectus that is a part of the registration statement.

5. The free writing prospectus rules exclude from the filing requirement any free writing prospectus that an offering participant distributes solely to its clients with no limitation on number of clients.

6. Rule 433 provides that if an issuer or offering participant fails to include a legend in a free writing prospectus, it must amend the communication to include the legend as soon as practicable and retransmit the communication, with the appropriate legend, by substantially the same means as and directed to substantially the same investors to whom the free writing prospectus was originally transmitted.

7. *See* Rule 433(f).

8. Under Rule 433, non-reporting and unseasoned issuers must have a statutory prospectus on file in order to engage in a communication with the media that would otherwise qualify as a media free writing prospectus. *See generally* Rule 433(b)(2)(ii). In effect, this means that the quiet period that currently applies to such issuers during the pendency of a registration statement would continue to apply once the new rules are adopted.

9. "Electronic road shows" are road shows "transmitted electronically by the Internet, videos, e-mail, CD-ROM or any other medium." Securities Offering Reform Proposing Release, Release No. 33-8501 (Nov. 3, 2004).

10. Issuers also are responsible for filing, and are responsible for, "issuer information" in the free writing prospectuses prepared by others. "Issuer information," in this context, refers to "material information about the issuer or its securities that has been provided by or on behalf of an issuer." *See* Rule 433(h).

11. Because of the liability considerations presented by free writing prospectuses, issuers and underwriters may also engage in additional due diligence activities to establish a due diligence defense. The parameters of these activities will likely vary until the industry has developed comfort with the new rules and until there is additional understanding about Section 12(a)(2) liability for free writing prospectuses. Presumably, some measures may include the solicitation of additional comfort letters from auditors and assurances from the issuer's counsel.

12. Similar to the issues raised by an issuer's redistribution of offering participant free writing prospectuses, an issuer or underwriter may become concerned about the extent to which information prepared and distributed by third parties may be attributed to such an issuer or underwriter. The SEC has indicated that issuers and other offering participants may be held liable under the free writing prospectus rules depending on whether the issuer or other offering participant has involved itself in the preparation of the information (*i.e.*, entanglement), or explicitly or implicitly endorsed or approved the information (*i.e.*, adoption). For example, a credit rating agency report distributed by an offering participant would be considered an offering participant free writing prospectus under an "adoption" theory, "if an issuer or underwriter distributes the rating agency report in connection with an offering of the securities." Addressing the question of entanglement, the SEC has indicated that liability under the entanglement theory depends upon the level of the issuer's or offering participant's pre-publication involvement in the preparation of the information. *See* Offering Reform Release, note 211.

13. *See* Bostelman and Kadel's article in this issue of *INSIGHTS* for a description of the changes to the shelf registration procedure.

14. A sale, for the purposes of the Securities Act, takes place at the time that an investor is contractually bound to purchase the securities. In a typical registered offering, this moment is generally viewed as occurring on the basis of oral confirmation regarding price and amount immediately after the effectiveness of the registration statement (or, in the case of a shelf registration, immediately after the pricing of the offered securities). Although well-advised capital markets participants have long understood that it is inadvisable to include information in the final prospectus that is materially different from that which is available to the investor at the time of pricing, there nonetheless are circumstances in which material changes were made to final offering documentation and delivered to purchasers after pricing and, in many instances, shortly before closing.

15. For example, in 2004, less than a week before it filed its Form S-1, Google's two founders were interviewed by *Playboy* magazine. Google informed the SEC that the interview would appear in the September 2004 issue of *Playboy*, which was to be published shortly before the commencement of the distribution. In response to these communications, and perhaps in response to SEC comment, Google: (i) amended the registration statement to include substantive and qualitative information from the interview; (ii) amended the registration statement to include risk factor disclosure about the Section 5 violation; (iii) amended the registration statement to include disclosure required by SFAS 5 in the footnotes to its

financial statements; (iv) attached the article as an appendix to the registration statement; and (v) recirculated the preliminary prospectus.

16. *See* Offering Reform Release at 111.

17. The consequences of making communications outside the registration statement or a safe harbor are more significant for unseasoned and non-reporting issuers. That is because, unlike well-known seasoned issuers and seasoned issuers, these issuers must accompany every free writing prospectus with a statutory prospectus. What this means, in effect, is that a communication outside the registration statement, even if treated as a free writing prospectus, creates an incurable violation of Section 5 for such issuers unless the communication is preceded or accompanied by a statutory prospectus.

18. *See, e.g.*, Charles Schwab & Co., Inc., SEC No-Action Letter (Feb. 9, 2000); Net Roadshow, Inc., SEC No-Action Letter (Jul. 30, 1997).

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