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IN THE KNOW
Leveraged Finance Newsletter

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144A VS REG S ONLY - CONSIDERATIONS IN HIGH YIELD OFFERINGS

The issuance of sub-investment grade debt in the EMEA debt capital markets often follows one of two "models" of transaction: the "US high yield model", which originated in and has a long history in the United States; and the "Eurobond" model, which developed in the European markets from debt practices in former emerging markets as they evolved towards more mature capital markets.

While offerings in the "Eurobond model" are often governed by English law, follow UK capital markets documentation standards and frequently exclude any offering into the United States, offerings in the "US high yield model" are usually governed by New York law, follow US high yield document standards, covenant packages and processes, and are structured to permit offerings to "qualified institutional buyers" in the United States.

Any offering of securities anywhere in the world must be either registered with the US Securities and Exchange Commission (the "SEC") or exempt. The two primary exemptions from such requirements that are most often utilized in international securities offerings are Rule 144A (offers and sales to qualified institutional buyers inside the United States) and Regulation S (sales to investors outside the United States in offshore transactions). These two exemptions commonly work in tandem, as described below.

For reasons discussed below, a transaction structured to permit offers to both investors in the United States pursuant to Rule 144A and to investors outside the United States pursuant to Regulation S--a so-called "144A/Reg S offering"--has traditionally been a more intensive, expensive and time-consuming process than an offering pursuant to Regulation S only without any concurrent Rule 144A offers to US investors (referred to as a "Reg S only offering"). As a result, Eurobond issuances are often structured as Reg S only offerings, depending on the anticipated target investor base and the jurisdiction of the issuer, among other factors.

In contrast, substantially all international "US high yield model" transactions in the EMEA markets have been structured as 144A/Reg S offerings. There are various reasons for this, including the ability to access the deep pool of experienced high yield investors in the United States; increased issuer visibility in the US market; additional certainty resulting from New York court-tested high yield documents and covenants governed by New York law; and efficiencies resulting from relying on well-established transaction processes in the US high yield market. Such deals are typically structured as 144A/Reg S offerings even when there is no actual offering made to any US investors, despite the extra time and expense required (compared to a Reg S only offering).

This raises the question: if a high yield offering is not actually offered to US investors pursuant to Rule 144A, would it be practical to consider structuring it as a Reg S only offering instead of as a 144A/Reg S offering that is typical of a "US high yield model" transaction? In this edition of *In the Know,* we examine some of the regulatory and market practice considerations relevant to this question.

US Regulatory Background

To understand the practical considerations relevant to the "144A/Reg S vs Reg S only" issue, it is helpful to have a background understanding of the key US securities laws involved.

EXEMPTIONS FROM SEC REGISTRATION

Under the US Securities Act of 1933, as amended (the "Securities Act"), an offer or sale of securities in the US must be registered with the SEC, unless an exemption from the registration requirements is available. Two such exemptions are those in Rule 144A and Regulation S under the Securities Act. Rule 144A provides an exemption for offers and sales to large "qualified institutional buyers" in the United States, while Regulation S exempts the offer and sale of securities to investors outside of the United States, both subject to compliance with certain other applicable eligibility requirements.

US SECURITIES LAW LIABILITIES

Although compliance with Rule 144A may exempt an offering to US investors from the registration requirements of the Securities Act, it does not exempt that offering from the antifraud provisions of the US federal securities laws. Accordingly, an issuer and the underwriters in a 144A/Reg S offering may be subject to securities law liabilities in the United States if the prospectus or other offering document contains "any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" (the so-called "10b-5 standard", named after a key US securities antifraud rule). A due diligence defense to this liability is available to the underwriters of the offering (although not the issuer).

In order to mitigate these potential liabilities, a 144A/Reg S offering will usually involve the following workstreams:

- **Disclosure**: Preparation of an offering memorandum containing robust disclosure substantially equivalent to what would be required in an SEC-registered offering--even though Rule 144A does not itself impose any such requirement. This is intended to ensure that, in accordance with the "10b-5 standard", no "material fact" is omitted from the disclosure for liability purposes. Consequently, the process of preparing an offering memorandum in a 144A/Reg S offering has traditionally been more time-consuming than a Reg S only offering.
- **Due diligence**: Because the underwriters in a 144A/Reg S offering have a potential due diligence defense to US securities liabilities, a detailed US-style due diligence process is undertaken by the underwriters and the outside counsels on the transaction, generally to a more in-depth degree than would necessarily be required on a Reg S only offering.
- **Comfort package**: To support their due diligence defense, the underwriters in a 144A/Reg S offering will also typically require the delivery to them of "10b-5 disclosure letters" from outside US counsel, and US-style "SAS 72" comfort letters from the issuer's auditors, intended to provide the underwriters with "comfort" as to the adequacy of the disclosure. As a result, the scope of the underwriters' comfort package is generally broader than what would be required in a Reg S only offering.

The additional work required in connection with these workstreams will require the engagement of US securities lawyers and will typically result in more time and cost than in a Reg S only offering.

Market Practice Considerations

Given the comparatively greater time and cost requirements in a 144A/Reg S offering as described above, high yield offering participants may sometimes evaluate the possibility of structuring the offering as a "Eurobond model" Reg S only offering. However, also relevant to any such evaluation are considerations of high yield market practice and the expectations of offering participants-particularly the investment banks acting as underwriters and investors.

DISCLOSURE

The robust level of disclosure required for a 144A/Reg S offering may pose unique challenges for certain types of issuers. For example, a public company listed in EMEA may not want to alter the form of its existing public disclosure.

Although international high yield offerings which are not offered to US investors are not necessarily subject to the same obligation to strictly comply with the "10b-5 standard" of disclosure as would be the case in a full 144A/Reg S offering, market practice in EMEA nevertheless tends to lean heavily towards the more robust 144A-style disclosure.

This is due in part to investor expectations but also potential reputational risk for the underwriters and issuer group. Because the process and practices of 144A/Reg S offerings are deeply embedded in the high yield market, international high yield investors expect 144A-level disclosure even in Reg S only offerings. Consequently, underwriters and other offering participants may be hesitant to undertake an offering with disclosure that deviates from well-established market practice and investor expectations--with the increased transaction risk and potential reputational risk that could result.

Historically, we have observed a convergence of the disclosure in Reg S only offerings towards more robust 144A-level disclosure as certain jurisdictions which historically favored the English law governed "Eurobond model" have begun to tap into the US capital markets, leading towards more expansive 144A-style disclosure (and, in certain circumstances, New York law style high yield covenant packages). Recent examples include Turk Telecom's "Covenanted Eurobond" issuance of USD 500 million 6.875% notes due 2025, which included a unique post change-of-control debt incurrence leverage test, and Geopromining's USD 300 million 7.75% notes due 2024, which are governed by English law but include a covenant package very similar to what we would expect in a standard New York law high yield offering, as well as expansive disclosure.

Despite the additional time and cost implications involved in preparing it, however, 144A-level disclosure provides certain ancillary benefits to issuers, particularly issuers that are at the pre-IPO stage in their business lifecycle. For example, the heightened 144A disclosure exercise may pave the way for a future IPO by establishing high-quality disclosure (as much of the issuer-descriptive disclosure in a high yield bond offering memorandum can be used for an equity offering document), commencing the due diligence process (which should be substantially the same between the due diligence process for an equity offering and a 144A high yield bond offering) and increasing institutional investor visibility (through ongoing reporting requirements and the marketing of the high yield bonds).

COMFORT PACKAGE

In addition to their desire to minimize transaction risk and reputational risks that could arise from accessing the high yield market with disclosure that is beneath a 144A-level standard, underwriters may also have difficulty in agreeing to accept a lesser comfort package that would also likely result therefrom. The high yield compliance committees and policies at many leading investment banks have historically required a full suite of US-style deliverables in an offering, including 10b-5 disclosure letters backed up by a full 144A-level due diligence exercise and SAS 72 comfort letters--all of which can only be delivered if the disclosure and diligence have been done to the appropriate standard. Proposals to deviate from this practice would likely prove challenging for many of the underwriters on a high yield offering.

Conclusion

As discussed above, we believe that the starting position for most international high yield offerings is likely to continue to be based on the 144A/Reg S offering structure, with 144A-level disclosure and comfort packages, even where the securities are not actually offered to US investors pursuant to Rule 144A. In any event, in such a transaction these considerations would need to be carefully considered and discussed with the underwriters and legal counsel involved in the offering at an early stage.

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