Cross-Border Liability Management and U.S. Federal Securities Law
The “New Security” Doctrine

In various circumstances, issuers of Eurobonds may seek to “amend and extend” the terms of outstanding securities either by means of a consent solicitation or, in instances of more acute financial distress, a creditor scheme of arrangement. Beyond the distress restructuring context, consent solicitations have also become an important tool in a changing regulatory landscape for financial institutions, principally banks and insurance companies. For many of these issuers, new capital requirements have required amendment of existing debt or hybrid instruments that do not count as regulatory capital under new rules for capital eligible securities in European Union jurisdictions and elsewhere. These amendments often involve changing maturity dates, amount of interest or the circumstances when interest or principal are payable – i.e., modifications of so-called “money terms”, which would require the unanimous consent of security holders had the securities been issued pursuant to an indenture qualified under the U.S. Trust Indenture Act of 1939 (the “Trust Indenture Act”).

Where the security subject to the consent solicitation has U.S. beneficial holders, a key structuring consideration is whether the proposed modification of terms is so substantial as to be deemed a de facto exchange offer for the existing security, thereby potentially triggering registration requirements under the U.S. Securities Act of 1933 (the “Securities Act”) and the tender offer rules under the U.S. Securities Exchange Act of 1934 (the “Exchange Act”). This is commonly referred to as the “new security” issue. Consent solicitations that implicate the “new security” doctrine generally should be structured so as to avoid or mitigate the risk of non-compliance with the registration requirements of the Securities Act and the tender offer rules under the Exchange Act.¹

U.S. case law on the new security doctrine is dated and the position of the U.S. Securities and Exchange Commission (the “SEC”) on the issue remains unclear. In particular, specific guidance with respect to the modification of Eurobonds is lacking. As a result, market practices have evolved on the basis of the risk assessments and risk appetites of market participants, with the aim to structure consent solicitations in a manner that eliminates or mitigates the risk of non-compliance under U.S. federal securities law and SEC enforcement action.

This note provides an overview of the new security doctrine and outlines some of the measures taken by market participants to avoid or mitigate the above risks.

Case Law and SEC Guidance

There is no single rule or statute that encapsulates the new security doctrine. Instead, the doctrine arises from (1) a line of U.S. case law, (2) “no-action” letters issued by the staff of the SEC and informal SEC staff comments and (3) commentary by legal academia and practitioners.

Stated generally, under the new security doctrine, there is a meaningful risk that a new security would be deemed to be created if the amendments sought in a consent solicitation change the “basic financial terms” of the subject debt securities. Basic financial terms are commonly thought to include payment of principal, interest rate, redemption premium, maturity, place of payment, currency and right to institute a default in such payment.²

When presented with the issue, U.S. courts have found that a new security was created in cases that included the following fact patterns:

> a proposal to repay 20% of the principal on the notes and extend the maturity of the remaining principal for either one or five years at holders’ option;³
> reduction of the interest rate by 1% in exchange for a prepayment and a premium increase of 0.5%;⁴
> extension of maturity and changes in interest payment dates, sinking fund payments and optional redemption prices.⁵

¹ The modification of particular terms of a debt security, or even the use of a pre-existing issuer substitution clause under a typical eurobond (especially if the eurobond is in bearer form) may also give rise to analytically distinct “new security” issues under U.S. federal tax law. While these issues are beyond the scope of this note, U.S. tax counsel should be consulted when material terms of a debt security are proposed to be modified or when it is proposed to substitute an issuer in reliance on a euromarket-typical issuer substitution clause contained in a bearer-form eurobond.

² See American Bar Foundation, Corp. Debt Fin. Project, Commentaries on Model Indenture Provisions (1986). As noted above, any amendments to these terms would also require the unanimous consent of holders under an indenture qualified under the Trust Indenture Act. Some of the existing U.S. court cases and SEC guidance described in this note and commentary by practitioners suggests that the “basic financial terms” of the security are at least contiguous (if not synonymous) with the terms that that can be changed only with unanimous consent under the Trust Indenture Act.


⁵ In re Northern Natural Gas Co., (Del.) 14 S.E.C. 506, 509 (1943).
> alteration of the voting, dividend or liquidation rights of a preferred equity instrument; and
> modification of investments in cattle (as part of a failed tax shelter), including amendments to extend payment terms and waives and endstop provisions, modified maintenance contracts with reduced monthly charges, a grant of additional cattle in exchange for additional maintenance charges, and individual payments of maintenance fees (which were seen by the court as a fresh commitment to the investments).

The most recent of these cases dates from 1945 and there have been few, if any, relevant rulings since then. In a 1975 case, a U.S. district court also considered whether a reduction in the conversion price of a security would constitute an offer and sale of a new security and concluded that it did not, noting, among other things, that (1) the modification was made in accordance with the terms of the indenture and (2) the change was advantageous to the holders.7

Guidance on the new security doctrine from the SEC or its staff is also dated and of limited utility to current market participants, especially in the cross-border/Eurobond space. Through the late 1980s, the SEC staff considered numerous no-action letter requests for determinations as to whether particular proposed modifications implicate the new security doctrine. For a wide range of proposed modifications presented by the letters, including covenant strips and even certain changes to money terms, the staff took the position that no new security would be created. However, in the early 1990s, in the wake of some of the more controversial restructurings of high yield bonds at the time, the SEC staff stated that it would no longer provide no-action guidance on whether a particular modification represented a new security. The SEC staff also informally considered expanding the circumstances under which it would deem an amendment to constitute an issuance of a new security. The latter position was never formalised, however, and the ability of market participants to rely on previously issued no-action guidance is generally understood to be somewhat limited given the lack of recent guidance and uncertainty over the SEC’s current position.

In light of existing case law guidance and the absence of any SEC or SEC staff action to the contrary, market practitioners generally take the position that the new security doctrine should not be implicated when a proposed modification does not have the effect of (i) extending the maturity, (ii) reducing or altering the due dates of payable principal or interest or (iii) modifying a redemption premium, place of payment, currency or the right to enforce upon a default in payment of principal and interest. In other cases, securities lawyers will advise that there is a substantial risk – the parameters of which are not always clear and are highly fact-intensive – that the SEC or a court could take the position that the modification was an offer of a new security.

Implications

A consent solicitation that is deemed to be an offer and sale of new securities is subject to the registration requirements of Section 5 of the Securities Act unless an exemption from such requirements is available. If the securities are issued without registration or an available registration exemption, the distribution may be subject to rescission under Section 12 of the Securities Act. In addition, the procedural requirements of Regulation 14E under the Exchange Act would apply on the basis that the consent solicitation is a deemed tender offer for the security that is being amended. Consent solicitations that implicate new security doctrine concerns should therefore be structured so as to mitigate the risk of non-compliance with the Securities Act and the tender offer rules under the Exchange Act.

In addition, transaction participants (including financial institutions that could be deemed to be acting as underwriters in such an offering) should consider potential disclosure liability under Section 10(b) of and Rule 10b-5 under the Exchange Act in respect of the consent document distributed to investors on the basis that such document would be deemed an offering document in respect of an offer of new securities.

For an issuer in financial distress, the risk of being deemed to be in breach of the foregoing requirements of U.S. securities laws and regulations may in some cases be of lesser importance than the immediate risk posed by the imminent maturity of a bond that it is unable to refinance or repay. For financial intermediaries, on the other hand, the relative importance of these considerations may be reversed, as major financial institutions generally take a very low-tolerance approach to the prospect of an SEC enforcement action or holder-instituted litigation in connection with a transaction, even if the risk was generally understood to be largely theoretical. These potentially competing interests should be taken into account when structuring consent solicitations that implicate new security doctrine concerns.

Compliance with the Tender Offer Rules under the Exchange Act

A consent solicitation that raises new security doctrine concerns is potentially subject to Regulation 14E under the Exchange Act. If no more than 10% of the target securities are beneficially owned by U.S. holders, issuers may be able to take advantage of the Tier I exemption from the procedural requirements of Rule 14e-1. Where the Tier I exemption is not available, transaction participants may choose to implement a consent period of at least 20 U.S. business days and take other measures in line with the procedural requirements of Rule 14e-1 as if these applied unambiguously to the transaction.

Exemptions from the Registration Requirements of the Securities Act

A consent solicitation that raises new security doctrine concerns could be structured so as to rely on one of the following exemptions from the registration requirements of the Securities Act.

> Regulation S. Where permitted under the terms of the relevant securities, issuers may choose to exclude holders located in the U.S. from participating in a consent solicitation. Where transactions are structured in this manner, no “offer” of a security would be made to holders located in the U.S., since they are never contacted. With implementation of appropriate “selling restrictions”, a transaction structured in this manner could comply with the exemption from the registration requirements of the Securities Act pursuant to Regulation S thereunder. However, under the terms of typical English law-governed Eurobonds, disenfranchisement of holders is not permissible and, as a result, an exclusionary structure typically cannot be implemented for these instruments.

> Section 3(a)(9) under the Securities Act. The Section 3(a)(9) exemption, which we discuss in detail in our note Debt Exchange Offers, may provide a potentially viable exemption from the registration requirements of the Securities Act in consent solicitations that implicate new

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6 Rochester Gas & Elec. Co., 21 S.E.C. 633, 634-36 (1945). Although the case concerns equity securities, modifications of the voting rights of holders in debt context could be argued to have the same consequence.


8 With respect to consent solicitations involving modifications of English law-governed Eurobonds, which have lower quorum and voting threshold requirements than bonds governed by a New York law indenture, it may be argued that even a modification of money terms should not result in the creation of a new security because the terms of the bond in substance already contemplate the possibility of making such changes without the unanimous consent of holders. There are no U.S. cases or rules directly on point, and there is some authority that could be interpreted to suggest a contrary conclusion.

9 The eligibility tests (and requirements for the look-through analysis to determine the level of beneficial U.S. ownership) for the Tier I exemption are described in further detail in our note Exemptions from the U.S. Tender Offer Rules.
security doctrine concerns and are deemed to be exchange offers. However, as with exchange offers, issuers seeking to rely on this exemption would be constrained in being able to compensate financial institutions for their roles as active solicitation agents and also potentially be required to qualify the amended trust deed under the Trust Indenture Act. As a result, market participants rarely rely on the Section 3(a)(9) exemption in consent solicitations that implicate new security doctrine concerns.

> **Rule 802.** Where U.S. holders beneficially own no more than 10% of the target securities, non-U.S. issuers have taken the position that a deemed exchange offer should be exempt from Securities Act registration under Rule 802 thereunder. In order to formally comply with the requirements of Rule 802, a number of transactions have included in the solicitation memorandum specific legends required by the rule and/or filed Form CB and Form F-X11 with the SEC. These formal steps to “perfect” compliance with Rule 802 are not taken in all consent solicitations that raise new security doctrine concerns, as the magnitude of the perceived risk (and therefore the need for remedial measures) varies from case to case, as do the institutional views of various frequent market participants as to the general advisability of furnishing Forms CB and/or F-X in deemed “new security” situations.

> **Section 4(a)(2).** Where U.S. holders of the target securities are either “qualified institutional buyers” as defined in Rule 144A under the Securities Act (“QIBs”) or institutional “accredited investors” as defined in Rule 501 of Regulation D under the Securities Act (“IAIs”), a consent solicitation that implicates new security doctrine concerns may be exempt from the registration requirements of the Securities Act under Section 4(a)(2). However, it is rarely possible for issuers or other transaction participants to identify all holders of the target securities, and therefore also difficult to confirm that all such holders are QIBs or IAIs. As a result, issuers and other transaction participants can rarely be assured that Section 4(a)(2) is available at the commencement of the consent solicitation process.

Finally, in instances where the target security is held by more than a de minimis number of U.S. holders, market participants seeking to modify the security in a manner giving rise to new security doctrine concerns may instead structure the relevant transaction as a full exchange offer, where the desired amendments will be reflected in the exchange “destination” securities, while the existing securities will be repurchased and retired. An exchange offer can be structured so as to be exempt from the registration requirements of the Securities Act and to comply with the tender offer rules under the Exchange Act. Structuring the transaction as an exchange offer is not always practical, however, as an exchange offer may not successfully eliminate holdout risks and is substantially more work-intensive.

**Other Structuring Mitigants**

Where issuers are unable to structure a consent solicitation that raises new security doctrine concerns to fully comply with one of the recognized exemptions from registration requirements of the Securities Act, a number of other structural features have been used to mitigate the risk that the consent would be deemed to be an offering of securities made in violation of these requirements. These mitigating measures are implemented by transaction participants to be able to construct a robust argument that aspects of the transaction were structured in a manner generally consistent with one or more recognised registration exemptions, and therefore did not amount to an impermissible offering of securities to the public. These mitigants have included the following features, among others:

> **Certification of status to participate.** While issuers may not exclude U.S. holders from voting under the terms of most English law-governed Eurobonds, they may request confirmation of investor status from meeting participants. In addition, issuers are not required to distribute consent solicitation materials to every investor on an equal basis so long as sufficient notice of a noteholder meeting is given. Accordingly, transaction participants may seek to minimise actions taken by holders in the United States and the extent to which a U.S. investor (or a U.S. investor that is not a QIB or IAI) is taking an effective investment decision with respect to a consent solicitation. Bondholders may therefore be required to certify that they are not located in the United States or, in some circumstances, that they are QIBs or IAIs in order to receive the consent solicitation memorandum and other consent materials. Where there are no participating U.S. holders or all participating U.S. holders confirm that they are QIBs or IAIs, issuers and other transaction participants should have a robust argument that the transaction is exempt from the registration requirements of the Securities Act by analogy to transactions exempt under Regulation S or Section 4(a)(2).

> **Voluntary supermajority to disenfranchise U.S. holders.** A Eurobond issuer may voluntarily condition the consent such that it would only regard the relevant amendments as passed if the required quorum and vote could be attained with the votes of only non-U.S. bondholders (or non-U.S. holders plus QIBs and IAIs). The purpose of this step is to implement a structure whereby an ineligible U.S. holder arguably did not make an effective investment decision. Holders whose votes counted for voting and quorum purposes, on the other hand, would have been eligible to participate in a transaction structured as a Regulation S offering and/or a private placement under Section 4(a)(2) of the Securities Act.

These mitigating measures do not satisfy the formal requirements of safe harbour exemptions from the registration requirements of the Securities Act and are not generally understood to be subject to coverage by a conventional “no-registration” legal opinion. Nevertheless, market participants from time to time proceed on the basis of these mitigating measures where the enforcement and liability risks posed by the new security doctrine are considered to be relatively low.

**Disclosure Liability and Other Considerations**

There has not been a uniform approach to addressing disclosure liability risk in circumstances where new security doctrine issues were potentially implicated. Depending on the circumstances of the consent and the issuer, including the issuer’s financial condition and the extent and nature of existing publicly available information about the issuer, the consent solicitation document may be bolstered with enhanced issuer information or the inclusion of business-specific risk factors. Other transaction participants have prepared a full prospectus-style disclosure document broadly comparable to what would be used for a primary offering of securities by the issuer. This approach is infrequently seen, however.

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11 The Rule 802 exemption from the registration requirements of the Securities Act is generally available in the same circumstances as the Tier I exemption from the tender offer rules under the Exchange Act. See our note Exemptions from the U.S. Tender Offer Rules.

11 Form CB is an informational filing, and is used to submit the exchange offer memorandum (or, in the case of consent solicitations, consent solicitation memorandum) to the SEC. Form F-X is used to appoint an agent for the service of process in the United States. Neither form is subject to SEC review. Rule 802 requires that the forms be filed no later than the first business day after the commencement of the offer.

12 See our note Debt Exchange Offers.

13 For an overview of exemptions from the registration requirements of the Securities Act for exchange offers, please see our note Debt Exchange Offers.
In a small number of cases, most often in the context of distress restructurings, investment banks assisting the issuer in a consent solicitation have sought to mitigate both reputational risk and the risk of underwriter liability in connection with the new security doctrine by removing their names from the consent document, functionally limiting their role to administrative functions and avoiding contacting investors in the United States, rather than acting fully as consent solicitation agents. In order to maximise the effectiveness of this approach, the compensation arrangement of an investment bank taking this step should be consistent with that of a financial adviser or information agent. Fee structures tied to the success of, or services performed in connection with, the consent solicitation should in that case be avoided. In any such situation, the activities of the financial intermediary must be carefully delineated and documented, and counsel should be consulted.

**In Brief**

The new security doctrine offers few clear parameters that define the extent of the risk that a particular consent solicitation could result in a deemed offer and sale of a new security in violation of the requirements of the Securities Act and the Exchange Act. Safe harbour exemptions from the registration requirements of the Securities Act, in particular, are often unavailable, leaving issuers and financial intermediaries to consider imperfect mitigating measures to soften ill-defined risks.

As a general rule, issuers and financial intermediaries in consent solicitations should be mindful that the market generally perceives there to be a risk that the SEC or a court would deem a modification to a debt security to amount to a new security where such modification would have the effect of (i) extending a maturity, (ii) reducing or altering the due dates of payable amounts of principal or interest or (iii) modifying a redemption premium, place of payment, currency or the right to enforce upon a default in payment of principal and interest. Considering U.S. federal securities law issues in these transactions in the structuring phase is advisable, even where the target securities were originally issued in a Regulation S-only offering.

Other notes in our Cross-Border Liability Management and U.S. Federal Securities Law series can be found [here](#).

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