
Over the Wall and Through the Woods: A Look at Wall-crossed Deals

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30 Jun 2009

Barring significant regulatory change, wall-crossed or pre-marketed deals have secured their place among well-established methodologies for executing financings. Several questions will have to be addressed during this process.

In the past two years, capital markets participants have learned to think about volatility differently. In the past, brief periods of market volatility generally interrupted longer periods of relative market stability. But now, we have begun to think of volatility in the capital markets as a norm. Issuers that need to raise capital - and the financial intermediaries that assist them in doing so - have become deeply concerned about skittish public markets and offering 'windows' that shut without much, if any, concrete provocation. In addition, numerous studies now confirm that market dynamics have changed such that the mere announcement of the 'launch' of a public offering is enough to result in shorting activity in the offered security, which tends to result in downward price pressure on the stock.

As a consequence of these developments, a variety of securities offering alternatives to fully marketed traditional underwritten public offerings have become more popular. We refer to these alternatives as 'hybrid financings'. Private investment in public equity (PIPE) transactions, Rule 144A offerings and registered direct offerings are examples of hybrid financings that have become increasingly more significant. While each transaction format has its advantages, they all tend to require that the issuer offer securities to investors at a discount to the prevailing market price of the issuer's common stock. This fact, combined with the view still held by many issuers that an underwritten offering will always be the most desirable financing alternative, has given rise to the development of yet another hybrid financing technique - known as a 'wall-crossed' or a 'pre-marketed' deal .

Wall-crossed Deals

A wall-crossed or pre-marketed deal culminates in an underwritten public offering that has been executed in two stages. The first stage (not visible to the market at large) involves confidential marketing (hence the reference to 'pre-marketing') by the issuer and the underwriter of the potential offering to selected institutional investors. These investors are often comprised of mutual funds, hedge funds, private equity investors and sovereign wealth funds. Some investors may be existing security holders. For SEC-registered transactions, it is necessary that the issuer have in place an effective shelf registration statement prior to commencing this first step. The issuer and the underwriter share with potential investors information that is not otherwise public, including the fact that the issuer is contemplating a possible financing, which will be executed as a firm commitment underwriting. The potential investors enter into confidentiality undertakings that require them to keep confidential the information conveyed to them by the issuer and refrain from effecting transactions in the issuer's securities until the information becomes public or is no longer considered current by the issuer.

Once indications of interest have been obtained from these anchor investors, the issuer files appropriate disclosure and selling documents, and the second stage of the process commences. After the information (which may be in the form of a press release, a free writing prospectus, a current report on Form 8-K, or a preliminary prospectus supplement) is released or filed by the issuer, the underwriter may include co-managers or syndicate members in the distribution. The underwriters then commence a more widespread marketing effort. This public selling process usually is commenced and completed in a few hours (often from the market close to the following morning) and rarely requires more than a day. Upon completion of the broader marketing, the offering is priced and proceeds to settle and close like any other underwritten follow-on offering.

Although the offering is a 'public' offering, it actually shares many features common to 'private' offerings, such as the targeted marketing approach and the sharing of issuer information on a confidential basis with potential investors that have agreed to refrain from trading for some period of time (often referred to as a standstill

period). Sharing information with potential investors on a confidential basis raises interesting disclosure and compliance considerations for issuers and their underwriters.

Sharing Information with Potential Investors

Since the mid-1930's, there have been penalties in place for the improper use of material non-public information and selective disclosure of such information to certain investors or industry participants. The SEC enacted Regulation FD, or Reg FD, to address selective disclosure by issuers. Reg FD encourages broad public disclosure by prohibiting the selective disclosure of material, non-public information except in certain situations. Selective disclosure occurs when an issuer provides third parties with material information about the issuer that is not known to the public. Selective disclosure is not problematic in all instances and often is warranted, for example, where an issuer shares non-public information with its advisers. However, selective disclosure is problematic when the issuer provides such information to securities market professionals or any of its security holders that can profit from, or avoid a loss because of, the information. Concerns about selective disclosure are heightened when an issuer is conducting a securities offering.

Materiality refers to the importance and relevance to the investing public of particular issuer information. Determinations regarding whether information is 'material' are highly fact specific and are invariably made with the benefit of hindsight. Case law suggests that information is 'material' if a reasonable investor would consider it important in making an investment decision. There must be a substantial likelihood that reasonable investors would have viewed disclosure of the fact omitted or misrepresented as having significantly altered the total mix of information available. In addition to the guidance provided by case law, the SEC, in adopting Reg FD, identified certain information or events that are potentially material, including, for example, earnings information, asset dispositions, and information about the issuer's securities (such as sales of additional securities or planned redemptions, repurchases or exchanges).

Information is 'non-public' if it has not been disseminated in a manner making it available to investors generally. If an issuer, or person acting on its behalf, discloses material non-public information to securities market professionals or company security holders that may trade on the basis of the information, the issuer must make public disclosure of that information. There are several exclusions from Reg FD, including an exclusion for communications made to any person that expressly agrees to maintain the information in confidence.

Obtaining executed confidentiality agreements from potential investors does not provide an issuer or underwriter with the right to disclose any information it chooses, but it does allow the issuer or underwriter to tell the potential investor about the offering. In addition, a confidentiality agreement generally protects the issuer from liability resulting from information leaks and ensures that potential investors are aware of the confidential nature of any financing discussion.

Reg FD requires that the agreement to maintain confidentiality must be express and provides that an oral agreement meets this requirement. However, it is recommended that an express oral agreement be documented subsequently through a written acknowledgment by the investor that the oral agreement was entered into at the time of the offer, along with a covenant that the purchaser will continue to keep the information confidential until the issuer publicly discloses details concerning the financing. Often, investors request that the issuer file a Form 8-K disclosing the financing within a certain period of time. Once a press release is issued, the investors and other potential investors contacted by the placement agent are released from their confidentiality undertakings and accompanying trading restrictions. From a practical perspective, an 'undisclosed' financing is accomplished most effectively when the marketing process is focused and compressed.

Best Practices for Issuers and Financial Intermediaries

That all sounds simple enough. But, the devil is in the details. In order not to compel a premature disclosure by the issuer, the underwriter must implement procedures designed to ensure that potential investors are aware of the confidential nature of the financing discussions. Generally, potential investors do not receive any material non-public information regarding the issuer or its business. Marketing materials are limited to an issuer's exchange act or other public filings or to a 'road show' type presentation that is viewed by pre-cleared investors. However, the fact that the issuer is considering a financing may itself constitute material non-public information.

In order to prevent premature disclosure of the potential offering, an issuer must ensure that, before the underwriter shares the issuer's name or other details with potential investors, the underwriter has obtained an undertaking from the potential investor that it will keep all such information confidential and refrain from effecting transactions in the issuer's stock. This is usually accomplished by the underwriter through the use of a 'script' that is intended to impart information to the potential investor in stages until the investor orally agrees to maintain the confidentiality of the shared information. The underwriter may then confirm this undertaking with an email that requires a reply from the investor.

From time to time, the issuer and the underwriter may agree to share other non-public information (not just the possibility of a financing) with investors during the pre-marketed phase. For example, an issuer may share details regarding its financial performance, including new earnings guidance, or information regarding a recapitalisation or a capital plan, or information regarding divestitures. All of this crosses over into the type of information that would certainly be considered 'material'. In the case where additional information of this sort is being shared, the issuer and the underwriter may determine that it is prudent to have each investor sign a non-disclosure or confidentiality agreement that specifically identifies the information and that contains more detailed standstill provisions and obligations on the issuer's part to make a public disclosure.

Within their organisations, investment banks will want to implement special compliance and other procedures for these offerings. For example, in order to contain the flow of information during the pre-marketing phase, an underwriter will likely limit the number of sales people involved in making investor calls. The underwriter will want to ensure that each person placing calls is adequately trained regarding the screening process, the use of the script, the email confirmation, etc. For compliance purposes, the underwriter will want to keep a record regarding the investors that it contacted and confirmation of receipt of the confidentiality undertaking.

Conclusion

Barring some significant regulatory change, wall-crossed or pre-marketed deals are here to stay. And they are likely to take their place among well-established methodologies for executing financings. As this is happening, several tricky questions will have to be addressed. For example, when does the information provided to selected institutional investors on a confidential basis typically become stale and therefore no longer constitute material non-public information? Or, does an issuer that abandons a proposed offering during the confidential stage have to disclose publicly that it attempted without success to finance. There are more unknowns, like these, lurking in the woods.