Strategic Uses of PIPE Transactions

Thursday, February 25, 2016

8:30 AM – 9:30 AM EST

Seminar

Presenters:

Anna T. Pinedo, Partner, Morrison & Foerster LLP
James R. Tanenbaum, Partner, Morrison & Foerster LLP

1. Presentation

2. Morrison & Foerster FAQ Guide:
   “Frequently Asked Questions about PIPEs”

3. Morrison & Foerster Summary Chart:
   “Exempt Offering Alternatives”

4. Morrison & Foerster Summary Chart:
   Investor Criteria for U.S. Private Placements and Other Offerings
What’s new with Privates and PIPEs

February 2016
Agenda

• Market trends
• Strategic uses of PIPE offerings
• “20% Rule”
• Regulatory developments
Market Trends
Market Trends

• Privates have become more “public”
  • In an effort to improve access to capital and minimize liquidity discounts, hybrid financing techniques have become more important
  • SEC’s Office of Risk Fin published a study in 2015 (“Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009 - 2014”) which showed that from 2009 to 2014 there was a shift from public to private or hybrid offerings
  • The shortened Rule 144 holding period, and the popularity of PIPE transactions, and other hybrids contributed to the rise of private or targeted offering techniques
  • The new Section 4(a)(7) resale exemption likely also will contribute to reducing the liquidity discount associated with “restricted securities”
  • JOBS Act changes to general solicitation rules will make privates even less private

• Perhaps more importantly, public offerings are becoming less “public”
  • Due to market developments, such as heightened volatility and concerns about investor front-running, fewer public offerings involve traditional marketing
  • Most public offerings begin as confidentially marketed public offerings
Market Trends (cont’d)

• Overall, companies rely on unannounced deals (PIPEs, registered directs, CMPOs)
• Reliance on unannounced deals is unlikely to abate
• As among deal formats, reliance on PIPE transactions has declined. More companies are eligible to use a Form S-3 for takedowns (completed as registered directs or as underwritten confidentially marketed public offerings). However, as has been the case since PIPE transactions were created, PIPE transactions become increasingly important in volatile markets.
# PIPE Market Trends

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Deals</th>
<th>Dollars Raised</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>981</td>
<td>$57 billion</td>
</tr>
<tr>
<td>2014</td>
<td>1,333</td>
<td>$34.6 billion</td>
</tr>
<tr>
<td>2013</td>
<td>1,275</td>
<td>$23.8 billion</td>
</tr>
<tr>
<td>2012</td>
<td>1,253</td>
<td>$36.1 billion</td>
</tr>
<tr>
<td>2011</td>
<td>1,246</td>
<td>$29 billion</td>
</tr>
<tr>
<td>2010</td>
<td>1,529</td>
<td>$39 billion</td>
</tr>
<tr>
<td>2009</td>
<td>1,272</td>
<td>$42 billion</td>
</tr>
</tbody>
</table>

*Data: Total Placements/Total Dollars 2009–2015

PrivateRaise.com
PIPEs: Structure Breakdown 2004–2015
## PIPEs by the numbers-2014

<table>
<thead>
<tr>
<th>Security Type (§ of Placements)</th>
<th>Security Type ($ millions raised)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock</td>
<td>772</td>
</tr>
<tr>
<td>Preferred Stock: Convertible</td>
<td>118</td>
</tr>
<tr>
<td>Preferred Stock: Non-Convertible</td>
<td>3</td>
</tr>
<tr>
<td>Debt: Convertible</td>
<td>149</td>
</tr>
<tr>
<td>Debt: Non-Convertible</td>
<td>32</td>
</tr>
<tr>
<td>Other: Convertible</td>
<td>2</td>
</tr>
<tr>
<td>Prepaid Warrant</td>
<td>27</td>
</tr>
<tr>
<td>Equity Line</td>
<td>73</td>
</tr>
<tr>
<td>Unknown</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td><strong>1176</strong></td>
</tr>
</tbody>
</table>
### PIPEs by the numbers-2015

<table>
<thead>
<tr>
<th>Security Type (Number of Placements)</th>
<th>Security Type (Number of Placements)</th>
<th>Security Type ($ millions raised)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock</td>
<td>678</td>
<td>$44,059</td>
</tr>
<tr>
<td>Preferred Stock: Convertible</td>
<td>122</td>
<td>$4,773</td>
</tr>
<tr>
<td>Preferred Stock: Non-Convertible</td>
<td>1</td>
<td>$5</td>
</tr>
<tr>
<td>Debt: Convertible</td>
<td>162</td>
<td>$6,136</td>
</tr>
<tr>
<td>Debt: Non-Convertible</td>
<td>27</td>
<td>$724</td>
</tr>
<tr>
<td>Other: Convertible</td>
<td>2</td>
<td>$7</td>
</tr>
<tr>
<td>Prepaid Warrant</td>
<td>27</td>
<td>$439</td>
</tr>
<tr>
<td>Equity Line</td>
<td>76</td>
<td>$888</td>
</tr>
<tr>
<td>Unknown</td>
<td>1</td>
<td>$5</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td><strong>1,097</strong></td>
<td><strong>$57,036</strong></td>
</tr>
</tbody>
</table>
Are PIPEs still relevant?
When is a registered offering better?
Strategic uses of PIPE transactions

- PIPE transactions remain an important alternative in a number of instances, including:
  - As a means of structuring a venture capital or private equity-type investment (which may take place in a distressed context)
  - In circumstances where the issuer is seeking to finance an acquisition
  - For a smaller issuer, when the smaller issuer has already tapped out its shelf registration statement or needs to preserve its shelf capacity
  - For selling stockholders (to place selling securityholder stock in an orderly way)
VC/Private equity PIPE

• Venture capital or private equity funds will often invest in public companies – either to increase their position or as a new investment if valuations make it attractive.
• Often a VC or a PE fund will invest in a public company as part of a recapitalization transaction.
• Why should these be structured as PIPE transactions?
  • Highly customized security;
  • Usually the investor will want to do its own diligence and is likely to acquire material and non-public information that will not be capable of being disclosed by the issuer after the transaction is completed (so the VC/PE firm will continue to be restricted);
  • The investors will likely want other contractual protections (affirmative/negative covenants, information rights);
  • The investors may want board representation;
  • The investors will not be as focused on their resale opportunities or if they are insiders/control persons will face other limitations
VC/Private equity PIPE (cont’d)

• These deals raise a host of issues that usually do not arise in other PIPE transactions:
  • Change of control issues:
    • Company’s agreements
    • Poison pill/rights plan
    • NASDAQ or other change of control provisions
  • Dilution for other shareholders and litigation risk
  • Change of control premium issues
  • Fiduciary duty and other governance issues
  • Fairness opinions
PIPE to finance an acquisition

• Why a PIPE?
  • Marketing reasons:
    • It may be important to share with potential purchasers a fair bit of information about the acquisition (all material non-public information) and restrict their ability to trade for an extended period of time
    • Important to assess when this information will be shared broadly and/or when the information will become stale
  • Lack of “current information:”
    • Is the acquisition material?
    • Is pro forma information required to be filed?
    • Pro forma information may not be available
    • A comfort letter may not be available that could cover the financial information

• These considerations may make it impossible to undertake a registered offering
PIPE to finance an acquisition (cont’d)

• Company would like to raise capital in advance of knowing whether its bid has been accepted

• Private placement option
  • Company will conduct a private placement to institutional investors
  • Placement Agent will wall cross institutional investors and institutional investors will agree not to trade in issuer’s stock (and, if public, in the target stock)
  • Placement Agent and Company will share with investors that are wall-crossed a PPM (or other offering materials)
  • Use of proceeds will describe potential acquisition — at least two alternatives:
    • Possible for proceeds to be escrowed and released only if Company is winning bidder, or
    • Proceeds would be released to Company regardless of whether Company prevails and wins the bid. Company would use proceeds for future acquisitions.
PIPE to finance an acquisition (cont’d)

- There are a number of special considerations if Company will pursue a private placement
  - Discount: will investors insist on a discounted price?
  - “Lock up”: will investors agree to be prevented from trading for a sufficiently long period of time? When will Company put out a release after definitive purchase agreements are executed? What will it say? What if the acquisition falls through? How will investors be cleansed?
- Liquidity: Investors will be focused on how quickly they can obtain liquidity
  - Company will need to agree to prepare and file a resale registration statement that covers the resale from time to time of the securities sold to investors in the private placement
  - Company and counsel will need to consider carefully the significance of the acquisition and, if significant, how long it will take to prepare the required historical financials and pro forma financials
PIPE to finance an acquisition (cont’d)

• Investors may exact a more significant discount if the periods to file a resale registration statement and/or to have the resale registration statement declared effective are longer than they would expect (typically period is usually 30 to 60 days)

• Securities Exchange rules: Nasdaq imposes shareholder vote requirements in various instances

• Big boy letters:
  • The investors should acknowledge receipt of information on target or the fact that they have not received combined financials
PIPE for smaller issuers

- Smaller issuers are subject to the 1/3 cap for primaries.
- Unfortunately, the cap may not provide sufficient flexibility for the issuer to raise much needed capital.
- An alternative for the issuer is to structure a PIPE or a 144A or other exempt offering alongside a take down off of a shelf (subject to the 1/3 cap):
- Things to consider:
  - General solicitation issues: an issuer contemplating a PIPE or other exempt offering in close proximity to a public offering should consider whether the public offering may have been a “general solicitation” that renders the offering exemption unavailable for the PIPE.
PIPE for smaller issuers (cont’d)

• Integration Issues:
  • offering only to QIBs and no more than two or three large institutional accredited investors (in reliance on no-action letter guidance), or
  • offering in reliance on Section 4(a)(2) and Regulation D
    • SEC CD&I Question 139.25 (Nov. 2008) clarified that under appropriate circumstances, there can be a side-by-side private offering under Section 4(a)(2) or Rule 506 with a registered public offering.
    • CD&I focuses on how the investors in the private offering are solicited – whether by the registration statement or through some other means that would not otherwise foreclose the availability of the Section 4(a)(2) exemption, such as a pre-existing relationship with the issuer.
**PIPE for selling securityholders**

- A significant securityholder or group of securityholders may wish to dispose of their securities.
- These securities may be restricted securities because:
  - They were acquired in an exempt offering, or
  - The securityholders are affiliates of the issuer (“control stock”)
- Why should these be structured as PIPE transactions?
  - Permits the securityholders to dispose of their securities in an organized manner without disrupting the market for the issuer’s securities.
  - Helps to avoid the downward pressure on the issuer’s stock price as a result of alternative means of disposing of the securities, such as:
    - Dribbling out securities over a period of weeks
    - Dumping the issuer’s stock in a block trade
  - The transaction is not announced until definitive purchase agreements are signed (the issuer’s stock will not suffer the downward pressure associated with an overhang).
PIPE for selling securityholders (cont’d)

• How is this accomplished?
• By utilizing the Section 4(a)(1½) exemption:
  • Can be used by institutional investors to resell restricted securities purchased in a private placement.
  • Can also be used by affiliates for the sale of control securities when Rule 144 is unavailable.

• In a Section 4(a)(1½) transaction:
  • The seller must sell in a “private” offering to an investor that satisfies the qualifications (for example, sophistication, access to information, etc.) of an investor in a Section 4(a)(2) private offering, and
  • The investor must agree to be subject to the same restrictions imposed on the seller in relation to the securities (for example, securities with a restricted legend).

• Other considerations:
  • Requires the issuer’s cooperation to effect the PIPE transaction.
  • Purchase agreement contains both issuer and selling securityholder reps & warranties.
PIPE Approaches for Companies that had been Planning US IPOs
Merging with and into an already public company

• Using the life sciences sector as an example, there are a number of public companies that were successful in raising capital to fund their clinical development, but which have failed trials.
• Instead of liquidating and distributing their capital to stockholders, these companies may be interested in considering merger opportunities.
• An issuer that has already commenced its IPO preparations but has found that its IPO has been delayed may consider a reverse merger into the already public company.
• Unlike the “reverse mergers” into shell companies, which raise a number of significant concerns, a reverse merger into an operating company can be a worthwhile alternative.
• Contemporaneous with the reverse merger, the company would undertake a PIPE transaction to raise additional funds.
Exchange Act listing, without a capital raise

- An issuer that already has undertaken the work required in connection with an IPO may find it worthwhile to repurpose its Form S-1 into a Registration Statement on Form 10, which is an Exchange Act registration statement, and list its securities on an exchange.
- The Form 10 enables an issuer to enter the SEC reporting regime.
- After a Form 10 is cleared through the SEC, the issuer will be a reporting company, responsible for periodic SEC filings, as well as subject to Sarbanes-Oxley requirements.
- A Form 10 registration statement cannot be used to raise capital.
- If the issuer wants to raise capital, it would have to conduct an exempt offering prior to, or alongside, the Form 10 registration process.
- The issuer usually will undertake a PIPE transaction.
Foreign exchanges

• Foreign securities exchanges, such as the AIM, the TASE, the Frankfurt exchange, and various of the Nordic exchanges, have been successful in attracting strong, technology-based companies across a range of sectors.

• Founders, sponsors, or others may have advocated to have these companies list their securities on these exchanges in order to create a liquidity opportunity, as well as to provide a “currency” for potential acquisitions or stock-based awards.

• However, many of these exchanges have failed to develop any real liquidity for their listed companies and the stocks have languished as a result of market structure issues (i.e., “small currencies,” lack of market makers, exchange rules), rather than as a result of company-specific concerns.
Recapitalization

The company could then be recapitalized as follows:

- An institutional private placement in the United States completed “at market” by reference to the home country securities exchange (which, by definition, will be lower than the valuation that would be ascribed for a similarly situated company listed on a U.S. securities exchange)
- In its home country, the company will undertake to register the resale of the securities purchased in the private placement
- The institutional private placement is followed by a rights offering in the company’s home country to existing stockholders, allowing existing stockholders to participate at the same price as the new institutional holders
- Contemporaneously with the institutional private placement and the rights offering, the company will proceed to undertake an IPO in the United States as an EGC relying on the confidential submission process; the IPO could include a resale component, or subsequent to the IPO, the company could file a resale for the institutional investors
Weighing the Alternatives
Why choose a registered direct?

- Over a PIPE transaction?
  - **Same efficient marketing**: If an issuer has an effective shelf registration statement, a registered direct offering can be marketed as a PIPE transaction — on a “stealth” basis.
    - Often a preliminary prospectus is filed, making the offering known to the public. However, the issuer and placement agent may agree not to file a preliminary prospectus supplement until late in the process.
  - **Often better pricing**: Investors receive registered, freely transferable securities, thus, no ‘liquidity’ discount.
  - **Prompt Pricing and Closing**: If the issuer has an effective shelf registration statement (or is a WKSI that can file an automatically effective shelf) the offering can be priced and closed promptly. In some cases, pricing can occur overnight or in a few days.
  - **Not limited to accredited investors**: Because these transactions are registered, offerings can be made to any potential investor, subject to suitability requirements.
Why choose a registered direct? (cont’d)

• Over a traditional underwritten follow-on offering?
  • **Short selling**: In a fully marketed underwritten offering, the market has advance notice of the potential offering, and market participants may begin shorting the issuer’s common stock in anticipation of the offering.
  • **Potentially better pricing**: Depending on the length of the marketing period and general market conditions, shorting activity in the issuer’s securities may cause the market price of the issuer’s stock to decline (sometimes significantly) by the pricing date. As a result, the pricing in a marketed follow-on generally may be lower than the price in a registered direct offering.
  • **Speed and Costs**: Registered directs are typically faster (and cheaper) than firm commitment deals.
  • **No capital commitment**: From the placement agent’s perspective, a registered direct offering does not require any capital.
Reminders for registered directs

- A registered direct is most efficient when the issuer already has an effective primary shelf registration statement.
- A selling stockholder also may use a registered direct offering to sell its shares—either alone or with primary (issuer) shares.
- A registered direct offering is a “distribution” for Regulation M purposes.
  - Assess the applicable Regulation M restricted period; file Regulation M notice.
- There is no overallotment option in a registered direct offering.
  - An overallotment option relates principally to stabilizing in connection with a firm commitment offering and is not applicable to a best efforts agency deal like a registered direct offering, where a specified number of shares are sold to the investors directly.
  - A placement agent cannot engage in market stabilizing transactions in a best efforts agency transaction, only in passive market making activities.
- NASDAQ and other 20% rule limitations are being applied to registered directs unless agents can demonstrate a broad distribution that includes retail investor participation.
- The 1/3 cap on primaries apply for smaller public companies.
Why a pre-marketed offering?

- Assumes that the issuer already has an effective shelf registration statement. Things to consider:
  - Will the eventual offering be a public or a private offering?
  - Is the issuer’s disclosure grid current? Is it necessary to file updated risk factors? Is it necessary to provide guidance on the current quarter? on write-downs? on anticipated ratings actions?
  - What is the best approach for updating the issuer’s disclosures (if needed)?
  - Plan ahead all of the required (or desired) filings (e.g., these may include: 8-K, preliminary prospectus supplement or FWP, term sheet, press release, final prospectus supplement).
Why a pre-marketed offering? (cont’d)

- Over a registered direct offering? In general, many of the advantages of a registered direct offering also apply in the context of a pre-marketed public offering.
  - **Wider distribution**: An advantage of a registered direct offering is that it is marketed in a targeted manner. However, that often means that the offering is not as widely distributed as other public offerings, in which case a pre-marketed public offering may be attractive (it can be opened up to retail investors).
  - **20% rule**: If an issuer anticipates offering and selling a number of shares that exceeds 20% of the total shares outstanding prior to the offering, and those shares will be sold at a discount, a registered direct offering may not be considered a “public offering” under the rules of the applicable exchange; thus presenting shareholder vote issues under the 20% rule. A pre-marketed public offering may be an attractive alternative because it is underwritten (important for NASDAQ) and in the second (public) stage can be opened up to a broader universe of offerees.
  - **Perceived better pricing**: Many issuers still view an underwritten offering to be the most desirable financing alternative.
  - **Underwriter can stabilize or over-allot** (if it chooses to do so): Depending on market conditions, this may be important.
NASDAQ Rule 5635 Requires Shareholder Approval for Certain Types of Transactions

• Issuances that may exceed 20% of the pre-transaction total shares outstanding ("tso") or voting power that are priced at less than the greater of book or market value
  • Sales by officers, directors and substantial shareholders may be aggregated with shares issued by the company

• Issuances that may result in a “change of control”
  • If a transaction results in an investor or group of affiliated investors obtaining a 20% interest, or the right to acquire such interest, in the issuer on a post-transaction basis the transaction will constitute a change of control for NASDAQ purposes
  • Notwithstanding, an exception exists for pre-existing control positions that are not displaced by the transaction
  • There are a number of ways to address the change of control issue, such as
    • Providing evidence that there are holders that have more sizable holdings and exert control
    • Ensuring that the new holder does not have special governance rights
    • Including a provision that holder will enter into a proxy so that any right to vote in excess of 19.9% will be voted with the majority
NASDAQ Rule 5635 Requires Shareholder Approval for Certain Types of Transactions (cont’d)

- Issuances that may exceed 20% of the tso or voting power of the issuer if they are connected with the acquisition of stock of another company or, more generally, with the acquisition of any asset(s)
  - This applies to both above and below market issuances
- Issuances in connection with an acquisition where an officer, director or substantial shareholder has a 5% or greater interest (or such persons collectively have a 10% or greater interest) in the company or assets to be acquired or in the consideration to be paid and the issuance of stock could result in an increase in outstanding common shares or voting power of 5% or more
NASDAQ’s Application of the Rules Generally

• The rules apply to issuances of equity securities and any security convertible into or exercisable for equity securities
• “Market price” is the consolidated closing bid price on the date immediately preceding the date of the execution of the fully binding, definitive agreement (cut-off for use of previous day bid price is 4:00 p.m. ET)
• NASDAQ no longer allows the use of a five-day average bid price and does not accept pricing mechanisms such as volume weighted average price (vwap)
Use of Share Caps and Pricing Floors to avoid exceeding the NASDAQ shareholder approval thresholds

- When the terms of the securities being offered create the potential for an issuance in excess of 20%, the company may avoid the need for up-front shareholder approval by including a cap on the number of shares that can be issued or a floor on the conversion price, such that no securities may be issued in excess of 19.9% of the pre-transaction total without shareholder approval.
Interpretative Material Regarding the Use of Share Caps or Pricing Floors – Alternative Outcome Transactions

• IM 5635-2 indicates that share caps and price floors are acceptable mechanisms to avoid the need to obtain shareholder approval prior to the completion of the transaction, provided:
  • The cap or floor remains in place for the life of the security or until shareholder approval is obtained (e.g., a cap which is only in place while an issuer is listed on NASDAQ will be deemed defective)
• Any shares issued pursuant to such a cap would not be eligible to vote with the shareholders on the removal of the cap or approval of the deal or any aspect of the deal
Interpretative Material Regarding the Use of Share Caps or Pricing Floors—Alternative Outcome Transactions (cont’d)

• Caps may not be used in connection with the issuance of securities that include “penalty” provisions or “sweeteners” (referred to as “alternative outcome transactions”), which are triggered based upon the outcome of the shareholder vote
  • A right of redemption would constitute a penalty provision unless the proceeds are held in escrow pending the shareholder vote
• Notwithstanding, the issuance of convertible securities with “sweeteners” or “penalties” may comply with the NASDAQ rules, provided that no equity securities are issuable prior to the shareholder vote
• Following a negative vote the securities may convert into up to 19.9% or the pre-transaction tso; however, additional votes to remove the cap would not be permitted pursuant to the alternative outcome policy
Aggregation of Offerings

For purposes of the 20% rule, NASDAQ will consider the following factors:

• Timing of the issuances (no safe harbor for transactions more than 6 months apart)
• Commonality of investors
• Existence of contingencies between the transactions (e.g., rights of first refusal or participation)
• Similarities between deal structures
• Commonalities as to use of proceeds
• Timing of the board of directors approvals

Note: NASDAQ will generally not aggregate a shareholder approved transaction or a public offering with a non-approved transaction
The Acquisition Rule

• An above market offering may fall under the acquisition rule rather than the 20% rule if it is completed in close proximity to an acquisition
• In determining which rule to apply to an offering, NASDAQ will rely on the following factors:
  • Proximity of the financing to the acquisition
  • Timing of the board approvals
  • Stated contingencies in the financing/acquisition docs
  • Stated use of proceeds

Note: Proceeds from an offering may be allocated among several uses to avoid triggering the rule
The Impact of Warrants on Equity Offerings

• The “blended average test”: If the common stock portion alone is less than the applicable NASDAQ threshold and is priced below the greater of market or book value, but the deal includes warrants that push the offering size over the threshold, the transaction will require shareholder approval – unless the warrant exercise price is at or above the greater of market or book value and the warrants are not exercisable for at least six months, in which case the warrants are excluded from the calculation.

• The $1/8 Test: If the common stock portion alone is more than the applicable threshold, NASDAQ will attribute at least $0.125 in value to the purchase of the unit for each share purchasable by a warrant, regardless of whether the exercise price exceeds the market price and book value.
A unit in a deal with 100% warrant coverage must be priced at least $0.125 above the greater of market or book value to avoid the need for shareholder approval (a six month exercise period will not be sufficient to exclude the warrants from the calculation).
Voting Rights

- The issuance of preferred stock that may convert at a discount to the market price of the common stock at the date of issuance and votes on a one for one basis with the common stock is a violation of the NASDAQ Voting Rights rule.

- **Note:** This can be addressed by limiting the voting rights of the preferred stock – for example: a preferred share that is convertible into common stock at a 20% discount to market will be deemed compliance if its voting rights are limited to 8/10ths of a vote.

- Contractual board designation rights must be in line with the capital contribution made by the investor and must include a “step down” in those rights as the investor liquidates the position.
Public Offering Exception

• It is important to note that NASDAQ’s shareholder approval rules do not apply to public offerings. In determining whether an offering qualifies as a “public offering” NASDAQ will consider the following factors set forth in IM5635-3:

  (i) the type of offering (including whether the offering is conducted by an underwriter on a firm commitment basis, or an underwriter or placement agent on a best-efforts basis, or whether the offering is self-directed by the Company);

  (ii) the manner in which the offering is marketed (including the number of investors offered securities, how those investors were chosen, and the breadth of the marketing effort);

  (iii) the extent of the offering's distribution (including the number and identity of the investors who participate in the offering and whether any prior relationship existed between the company and those investors);

  (iv) the offering price (including the extent of any discount to the market price of the securities offered); and

  (v) the extent to which the company controls the offering and its distribution.
Public Offering Exception (cont’d)

- In determining whether an offering qualifies as a “public offering,” NASDAQ will also consider whether the offering was marketed to retail investors. In addition, in most instances, NASDAQ will expect the company to issue a press release announcing the offering in advance of the completion of the marketing effort.
- A standard rights offering and an “at the market” offering are generally considered “public”
Methods for obtaining Interpretative Guidance from NASDAQ

- Telephone Interpretation – non-binding regardless of whether the issuer’s name is provided
- Submission of Listing of Additional Shares (“LAS”) filing for the transaction with cover letter laying out support for conclusion and providing additional transaction detail – non-binding, but supports presumption that the transaction complies with all NASDAQ shareholder approval and voting rights rules and policies so long as NASDAQ provides an email confirmation that they have completed their review
Methods for obtaining Interpretative Guidance from NASDAQ (cont’d)

• Submission of formal request for Interpretative Guidance to the Staff – Binding Guidance
  • Requires a $15,000 Non-refundable fee for accelerated consideration (one to four weeks) or a $5,000 fee for regular course consideration (four weeks or so)
  • Requires sign off from the Listing Qualifications Department and two attorneys from the NASDAQ Office of General Counsel

Note: Do not assume that a transaction is compliant simply because a similar structure has been accepted in the past. The rules and policies evolve continuously, often in the absence of rule filings and written interpretive guidance
Nasdaq request for comment

- Over time, Nasdaq has not made significant changes to its shareholder approval rules
- The request for comment addresses various aspects of the shareholder approval rule, including change-of-control provisions, the warrant test, the private placement provisions, and the acquisition rule
- Specifically, Nasdaq asks whether
  - The 20% threshold (i.e., requiring shareholder approval for issuances of 20% or more of pre-transaction total shares outstanding at a discount) is too restrictive?
  - Whether the percentage should be higher?
  - Whether there are other shareholder protection provisions that are sufficient?
  - Whether the insider interest in acquired assets test is still needed?
- The comment period closed February 15, 2016, but Nasdaq welcomes comments at any time.
Regulatory Developments
Regulatory developments

• Changes to the definition of “accredited investor”

• New resale exemption, Section 4(a)(7)
  • One could envision relying on Section 4(a)(7) for a selling stockholder PIPE (instead of relying on Section 4(a)(1-1/2) although it is difficult to establish a persuasive rationale to do so
  • Section 4(a)(7) could be helpful for a PIPE purchaser if the PIPE purchaser wants to resell before the effectiveness of the resale registration statement

• SEC enforcement issues associated with pre-IPO (private company) securities trading

• FINRA focus on private offerings
FREQUENTLY ASKED QUESTIONS ABOUT PIPES

Understanding PIPES

What are “PIPES”?

A PIPE (Private Investment in Public Equity) refers to any private placement of securities of an already-public company that is made to selected accredited investors (usually to selected institutional accredited investors). See “How is ‘accredited investor’ defined?” In a typical PIPE transaction, investors enter into a purchase agreement that commits them to purchase securities and usually requires the issuer to file a resale registration statement covering the resale from time to time of the privately purchased securities.

Equity lines of credit are not PIPE transactions. See “What is an equity line of credit?” below.

Are all public companies permitted to engage in PIPE transactions, or are there eligibility requirements?

Yes, all public companies that are reporting companies may engage in PIPE transactions. See Requirements for an Issuer below.

Is there a limit to the number of purchasers that may participate in a PIPE transaction?

If all of the offerees are accredited investors, there is no limit on the number of offerees or purchasers that may participate in a PIPE transaction. See “How is ‘accredited investor’ defined?” below. However, to the extent that the issuer and the placement agent intend to rely on the exemption from the registration requirements under Section 4(a)(2) of the Securities Act of 1933, as amended (the “Securities Act”) and the Rule 506(b) safe harbor, the placement agent must take care not to engage in any marketing or sales activity that would constitute a “general solicitation.”

How is “accredited investor” defined?

Rule 501 promulgated under Regulation D of the Securities Act sets forth the definition of an “accredited investor.” The definition was updated following the passage of the Dodd-Frank Act.

What kinds of securities are sold in PIPE transactions?

PIPE transactions may involve the sale of common stock, convertible preferred stock, convertible debentures, warrants, or other equity or equity-like securities of an already-public company.

There are a number of common types of PIPE transactions, including:

- the sale of common stock at a fixed price;
- the sale of common stock at a fixed price, together with fixed price warrants;
• the sale of common stock at a fixed price, together with resettable or variable priced warrants;
• the sale of common stock at a variable price;
• the sale of convertible preferred stock or convertible debt;
• a change of control transaction; and
• a venture-style private placement for an already-public company.

What are some of the advantages of a PIPE transaction?

A PIPE transaction offers several significant advantages for an issuer, including:

• transaction expenses that are lower than the expenses that an issuer would incur in connection with a public offering;
• the issuer will expand its base of accredited and institutional investors;
• for fixed price transactions, investors will have less incentive to hedge their commitment by shorting the issuer’s stock;
• the transaction will be disclosed to the public only after definitive purchase commitments are received from investors;
• investors receive only very streamlined offering materials or information, including publicly filed Exchange Act reports; and
• a transaction can close and fund within seven to ten days of receiving definitive purchase commitments.

Some of the advantages for an investor include receiving a discount to the current market price (in order to compensate for the initial resale restrictions) and, once the SEC declares the resale registration statement effective, having unrestricted, freely tradeable securities.

What are some of the weaknesses of a PIPE transaction?

PIPE transactions have a few disadvantages for issuers, including:

• investors will require a discount to market on the purchase price (in order to compensate for the initial resale restrictions);
• there will be a limit on the number of “black-out” periods for the issuer while the resale registration statement is effective (see “What is a ‘black-out’ period?” below);
• as a general matter, the offering can only be marketed to accredited investors (see “How is ‘accredited investor’ defined?”); and
• an issuer cannot sell more than 20% of its outstanding stock at a discount without receiving prior stockholder approval. See “Does a PIPE transaction require any prior approvals from regulatory agencies or self-regulatory organizations?” below.

Traditional PIPE Transactions

What is a traditional PIPE transaction?

A traditional PIPE transaction is a private placement of either newly-issued shares of common stock or shares of common stock held by selling stockholders (or a combination of primary and secondary shares) of an already-public company that is made through a placement agent to accredited investors.
Investors in a traditional PIPE transaction commit to purchase a specified number of shares at a fixed price, and the issuer commits to filing a resale registration statement covering the resale from time to time of the purchased shares. The closing is conditioned upon, among other things, the SEC's preparedness to declare that resale registration statement effective.

**What is a “black-out” period?**

In connection with a PIPE transaction, an issuer typically must keep a resale registration statement effective for an agreed-upon length of time so that the securities may be sold freely, without reliance on Rule 144. During this period, the issuer may suspend the use of the resale registration statement to amend it or to remedy a material misstatement or omission. This suspension is often referred to as a black-out period. During a black-out period, PIPE purchasers will have limited liquidity, as they will not be able to rely on the resale registration statement to sell the securities purchased in the PIPE transaction. Investors will negotiate a limit on the length and number of black-out periods. A black-out period also may be referred to as a “suspension period.”

**How do traditional PIPE transactions differ from non-traditional PIPE transactions?**

In a traditional PIPE transaction, investors enter into a definitive purchase agreement with the issuer in which they commit to purchase securities at a fixed price. Thus, the investor bears the price risk from the time of pricing until the time of closing—a period ranging from three to thirty days, depending on the SEC's review of the resale registration statement. The issuer is not obligated to deliver additional securities to the PIPE investors if the stock price fluctuates (or for any other reason).

Investors in a traditional PIPE do not fund when they enter into a purchase agreement. Instead, the issuer then files a resale registration statement covering the resale from time to time of those securities by the PIPE investors. The transaction closes once the SEC indicates its preparedness to declare the resale registration statement effective. Consequently, investors in a traditional PIPE transaction have a resale registration statement available at the time of closing.

Non-traditional transactions generally are structured as private placements with follow-on (or trailing) registration rights. This means that a closing is scheduled when investors enter into a definitive purchase agreement. Investors fund and the transaction closes. Post-closing, the issuer has an obligation to file a resale registration statement and use its best efforts to have it declared effective.

Typically, the purchase agreement or a separate registration rights agreement outlines specific deadlines for the issuer to file, and then to seek effectiveness of, the resale registration statement. Some PIPE transactions require the issuer to make penalty payments for failure to meet those deadlines.

In the case of a PIPE structured as a private placement with follow-on registration rights, the investor will not have the benefit of a resale registration statement for some time—usually 45 to 90 days following the closing. During that period, investors will hold restricted securities.
What are the standard terms of a traditional PIPE transaction?

A traditional PIPE transaction generally involves the following features:

- private placement to selected accredited investors;
- investors irrevocably commit to purchase a fixed number of securities at a fixed price, not subject to market price adjustments or to fluctuating ratios;
- purchase agreements generally contain a limitation on black-out periods;
- immediately following execution of purchase agreements with investors, the issuer files a resale registration statement covering resales from time to time of the restricted securities to be sold in the transaction, naming the purchasers as “Selling Stockholders”;
- closing of the PIPE transaction occurs promptly upon notice of the SEC’s willingness to declare the resale registration statement effective; and
- the resale registration statement is effective until shares may be sold free of restrictions under Rule 144.

Do investors conduct their own due diligence in a PIPE transaction?

Investors generally limit their diligence investigation to discussions with management and the company’s independent auditors. Traditional PIPE purchasers generally do not negotiate for themselves ongoing negative covenants or covenants relating to information rights or corporate governance.

When does the PIPE purchaser in a traditional PIPE transaction pay for the securities?

No money is exchanged when the purchase agreement is executed. Purchasers pay the purchase price only when they are informed that the resale registration statement is ready to be declared effective.

What are the other closing conditions for a traditional PIPE transaction?

A traditional PIPE transaction generally involves the following closing conditions:

- the issuer must update the representations and warranties made in the purchase agreement (which are similar to those contained in an underwriting agreement) and deliver a comfort letter and legal opinions (including a 10b-5 negative assurance relating to the private placement memorandum and the resale registration statement) to the placement agent;
- there can have been no material adverse change since execution of the purchase agreement; and
- the SEC must have stated its willingness to declare the resale registration statement effective.

Does the placement agent or a lead investor control the process in a traditional PIPE transaction?

In a traditional PIPE transaction, the process is controlled by the placement agent, rather than by a lead investor. The placement agent conducts its own business and financial due diligence.
Purchasers will receive legended securities at the closing. However, a purchaser can receive clean (unlegended) securities—either at the closing or afterwards—by delivering to the issuer’s transfer agent a certificate (in contemplation of transferring or otherwise disposing of the shares) acknowledging that the purchaser recognizes its obligation to deliver a prospectus to any prospective purchaser of the shares and making certain representations concerning future sales of the shares.

Typically, the resale registration statement is declared effective on the day of (but subsequent to) the closing or on the following business day.

**How does a traditional PIPE transaction settle?**

A traditional PIPE transaction settles outside of the DTC (Depository Trust Company) system. Investors receive actual physical stock certificates representing the securities. The issuer works with its transfer agent to make arrangements for the closing of the transaction.

**What are the benefits of traditional PIPE transactions compared to non-traditional PIPE transactions?**

By comparison to a non-traditional PIPE transaction, which is structured as a private placement with follow-on registration rights, a traditional PIPE transaction involves less uncertainty, market risk, and illiquidity.

Purchasers in a traditional PIPE transaction are not required to close until a resale registration statement is available for subsequent sales of the purchased shares. Traditional PIPE purchasers can obtain unlegended shares at, or shortly after, closing, which allows them flexibility in disposing of the shares.

For most registered investment funds, securities purchased in a traditional PIPE transaction are counted in the funds’ public basket.

---

**Non-traditional PIPE Transactions**

**What are the standard terms of non-traditional (or structured) PIPE transactions?**

A non-traditional (or structured) PIPE transaction generally involves the following features:

- a private placement to selected accredited investors;
- investors commit to purchase securities at a fixed price or at a variable/reset price;
- for transactions involving variable/reset pricing, the purchase agreement generally contains specific pricing parameters, which may include a cap on the maximum number of shares that may be issued to the PIPE purchasers;
- the purchase agreement generally contains a limitation on black-out periods;
- the transaction closes and funds promptly after investors execute purchase agreements;
- the issuer files a resale registration statement covering resales from time to time of the restricted securities sold in the PIPE transaction, naming the purchasers as “Selling Stockholders”;
- the issuer may be obligated to make penalty payments if it fails to file the registration statement within an allotted period, or if the issuer fails to use its best efforts to have the
registration statement declared effective within a defined period; and

- the resale registration statement is kept effective until shares may be sold freely under Rule 144.

When does the purchaser pay for the securities in a non-traditional PIPE transaction?

In a non-traditional PIPE transaction, the purchaser pays for the securities at the closing, which takes place promptly after the execution of all of the applicable purchase agreements. Purchasers pay for and receive restricted securities bearing a Securities Act legend. Unlike purchasers in a traditional PIPE transaction, purchasers in a non-traditional PIPE transaction will not have the immediate benefit of an effective resale registration statement.

What are other closing conditions and covenants in non-traditional PIPE transactions?

A non-traditional PIPE transaction generally involves the following closing conditions:

- the purchase agreement contains standard representations and warranties (similar to those contained in an underwriting agreement), which will be brought down at closing;
- for variable/reset deals, the purchase agreement also may contain covenants requiring the future issuance of additional securities by the issuer at no cost to the purchaser;
- the purchase agreement may, depending on the nature of the purchaser, contain ongoing covenants relating to corporate governance (board representation or observer rights, blocking rights, etc.) or information requirements (regular deliveries of public filings or other information to the purchaser);
- the issuer must deliver a comfort letter and legal opinions to the placement agent;
- each investor must deliver to the issuer and the issuer’s transfer agent a certificate as to the investor’s compliance with the prospectus delivery requirements in order to obtain unlegended stock certificates in the future; and
- there can have been no material adverse change since execution of the purchase agreement.

Do purchasers receive restricted (legended) securities at closing?

Yes. At the closing of a non-traditional PIPE transaction, purchasers receive legended securities.

Typically, purchasers will hold these restricted securities for a period of 45 to 90 days (or longer) following the closing. During this period, the issuer will file the resale registration statement with the SEC and seek to have it declared effective. If the issuer fails to meet any of the deadlines for filing or effectiveness outlined in the purchase agreement, the issuer may be required to make penalty payments to the purchasers.

Purchasers have limited liquidity while the resale registration statement is pending. Once the resale registration statement is declared effective, the purchasers can sell their securities pursuant to the resale registration statement, although they will be required to deliver their legended stock certificates and a legal opinion to the transfer agent in advance of any trade. This process often results in significant delays.
Is a registered direct transaction a PIPE?

Although some of the features of a registered direct offering (i.e., sales to selected institutional investors by a placement agent) give it the appearance of a private placement, a registered direct offering is a public offering. The offered securities are sold pursuant to an effective registration statement. Investors receive a preliminary prospectus (or red herring) during the marketing phase and a final prospectus prior to closing. The offering closes through DTC and investors receive their shares through DTC rather than receiving physical certificates like they would in a PIPE transaction.

Typically, PIPEs are priced at a modest discount to the closing bid price for the stock to compensate for the temporary illiquidity of the purchased shares. Often, in variable/reset transactions, the price is set based on a formula that relates to the average closing price of the stock over several days preceding the pricing.

Who bears price risk?

In a fixed price transaction, the purchaser bears the price risk during the period from execution of the purchase agreement until the closing.

In a variable/reset price transaction, the price risk is shared between the investor and the issuer. Usually, the investor will negotiate some price protection for itself.

What are the other frequent negotiating points in PIPE transactions?

In addition to negotiating specific carve-outs for representations and warranties, the placement agent, purchaser, and issuer typically negotiate the following points:

- whether issuer’s counsel will include a 10b-5 negative assurance in its opinion;
- whether the issuer will be required to cause its independent auditor to furnish the placement agent (if any) with a comfort letter at closing;
- whether there will be a limitation on the length and number of black-out periods;
- whether there will be a time limit for filing the resale registration statement following execution of the purchase agreements;
- the length of time given to the issuer to have the resale registration statement declared effective (most often 60 days); and

Pricing and Other Negotiating Points of PIPE Transactions

Will purchasers agree to purchase securities at a fixed price or a variable price?

PIPE transactions may be fixed price or variable/reset price transactions.

Variable/reset price transactions often include price protection. For example, investors seek “downside protection” by negotiating rights for themselves that protect the value of their investment in the event of a downward price fluctuation. Conversely, issuers may negotiate a “cap” or “floor” to limit their exposure with respect to the maximum number of shares that may be issued as a result of stock price fluctuations or other conditions.

How is the price set?

The price is set through discussions between the placement agent and the issuer, just as it is during the course of an underwritten (firm commitment) offering.
• whether there will be penalty payments tied to the filing and effectiveness of the resale registration statement.

Sharing Transaction Details with Potential Investors

Who may participate in PIPE transactions?
Accredited investors are eligible to participate in PIPE transactions. Funds, including mutual funds, pension funds, and hedge funds, are frequent PIPE purchasers. More recently, distressed funds and venture funds have begun participating in PIPE transactions. Distressed funds and venture funds typically negotiate additional covenants in their purchase agreements relating to corporate governance rights and information rights.

What information do investors receive?
All investors in a PIPE transaction receive the same information: a private placement memorandum containing the issuer’s Exchange Act documents. Investors generally do not receive projections or other information that has not been disclosed publicly.

Should investors sign a confidentiality agreement?
Because investors do not receive material nonpublic information, it may not be necessary for them to sign a general confidentiality agreement. However, the issuer will be sharing information (the fact that the issuer is considering a financing transaction) that is not known to the market. Thus, the placement agent and the issuer should obtain from each prospective investor an oral or written agreement stating that the investor will keep information relating to the potential offering confidential and acknowledging that the investor understands how confidential information must be treated under the securities laws. Any such agreement should contain an express agreement to refrain from trading in the issuer’s securities. See “Regulation FD and other Legal Concerns.” Given an already-public company’s desire to keep information about a potential financing in the form of a PIPE transaction confidential until such time as a definitive agreement is executed, it would be inconsistent for the issuer and/or the placement agent to use general solicitation in connection with a possible transaction.

Will investors know what a PIPE transaction is?
There are many misconceptions about PIPE transactions, but typically, within each institution, there is a compliance or legal person who is familiar with the PIPE structure.

PIPE transactions have received negative press in the past. How does the market view PIPEs today?
In the past, PIPEs have been confused with death spiral transactions and equity lines of credit. See “What is a death spiral or toxic convert?” and “What is an equity line of credit?” below. Unlike PIPEs, these transactions can result in ongoing and substantial dilution. Also, the SEC’s enforcement division has brought a number of actions against hedge funds and other investors in PIPE transactions that traded in advance of the public announcement of the transaction while in possession of material nonpublic information or that engaged in manipulative trading practices in connection with PIPE transactions.

PIPE deals have grown in popularity over the past few years. The types of issuers taking advantage of the PIPE structure has broadened from small companies to New York Stock Exchange traded companies. In addition, the numerous publications, websites, and conferences
that cover the PIPE market have made the PIPE structure more familiar to investors.

Requirements for an Issuer

What kinds of issuers finance through PIPE transactions?

Historically, PIPE transactions have been used by issuers with significant capital requirements, including life science and biotech companies, real estate investment trusts, and technology companies.

In recent years, as the volume of PIPE transactions has increased, the variety of issuers coming to market with PIPE transactions also has increased. PIPE issuers now range in size and include larger, more established companies. These issuers usually view PIPE transactions as an alternative to shelf takedowns, traditional follow-on offerings, or bought deals. In addition, many issuers use PIPE transactions to provide liquidity to existing stockholders. In some instances, where a shelf takedown may not be possible, such as in connection with financing an acquisition, a PIPE transaction may be the only choice.

What are an issuer’s typical considerations relating to a PIPE transaction?

In evaluating a PIPE transaction as a possible financing option and in considering a PIPE transaction versus other potential financing options, an issuer should generally consider the following:

- usually the issuer cannot issue more than 20% of its total shares outstanding at a discount in the PIPE transaction without shareholder approval and prior notification to exchanges

(see “Does a PIPE transaction require any prior approvals from regulatory agencies or self-regulatory organizations?”) below;

- the purchaser (not the issuer) bears market risk;

- the transaction can close quickly, provided there is no SEC review;

- the format is familiar to sophisticated institutional investors;

- PIPEs typically involve a modest discount to market price;

- the SEC is comfortable with the PIPE format; and

- PIPEs do not have any of the negative effects associated with a “death spiral,” preferred stock offering, or an equity line of credit. See “What is a death spiral or toxic convert?” and “What is an equity line of credit?” below.

Must an issuer be eligible to use a Form S-3 registration statement on a primary basis in order to complete a PIPE transaction?

Issuers need not be Form S-3 eligible on a primary basis in order to complete a PIPE transaction, but must be eligible to use Form S-3 on a resale basis. An issuer may use a Form S-1 or a Form S-3 registration statement as a resale shelf registration statement in connection with a PIPE transaction, but using a Form S-3 is cheaper and less time-consuming than using a Form S-1. The Form S-3 is less burdensome and may be updated by the periodic filing of Exchange Act reports, without the need to file post-effective amendments.
What are the eligibility requirements for use of a Form S-3 registration statement for resales?

In order to use Form S-3 for resales (secondary shares):

1. An issuer must:
   - be organized, and have its principal business operations, in the United States or one of its territories;
   - have a class of securities registered pursuant to Section 12(b) of the Exchange Act or a class of equity securities registered pursuant to Section 12(g) of the Exchange Act, or be required to file reports pursuant to Section 15(d) of the Exchange Act; and
   - have been public and have timely filed all required filings for a period of at least 12 calendar months immediately preceding the filing of the Form S-3 and have filed all required reports in a timely manner; and

2. The issuer, and its consolidated and unconsolidated subsidiaries, must not, since the end of the last fiscal year for which certified financial statements of the issuer and its consolidated subsidiaries were included in an Exchange Act report:
   (1) have failed to make any required dividend or sinking fund payment on preferred stock or
   (2) defaulted on the terms of any borrowing or on any long-term lease, which defaults in the aggregate are material to the financial position of the issuer and its consolidated and unconsolidated subsidiaries, taken as a whole.

May an issuer use an existing shelf registration statement to complete a PIPE transaction?

Generally, if an issuer has a shelf registration statement on file, it is a primary shelf registration statement covering the sale by the issuer of its newly issued securities. An issuer may have a shelf registration statement on file that includes primary (issuer) shares and secondary (selling stockholder) shares. In that case, the issuer may be able to use that registration statement for a PIPE and name the PIPE purchasers as the “selling stockholders.” Generally, though, the issuer must file and have declared effective a resale registration statement covering the resale by the PIPE purchasers (a selling stockholder shelf registration) from time to time of the securities that were purchased in the PIPE transaction.

Does a PIPE transaction require any prior approvals from regulatory agencies or self-regulatory organizations?

A PIPE transaction may require prior approval from the exchange on which the issuer’s common stock is quoted if the transaction will be completed at a discount and may result in the issuance of 20% or more of the issuer’s total shares outstanding. The issuer should consider not only the effect of completing the proposed PIPE transaction, but also, if the issuer has completed other private transactions within the same six-month period, the aggregate effect of such transactions, all of which may be aggregated by the exchange. Each of the New York Stock Exchange, the NYSE MKT, and Nasdaq has a similar requirement.

A New York Stock Exchange-listed company must comply with Rule 312.03(c), which requires that the issuer obtain shareholder approval prior to the issuance of common stock, or of securities convertible into or exercisable for common stock, in any transaction or series of related transactions if: (1) the common stock has, or will have upon issuance, voting power equal to,
or in excess of, 20% of the voting power outstanding before the issuance of such stock or of securities convertible into or exercisable for common stock; or (2) the number of shares of common stock to be issued is, or will be upon issuance, equal to, or in excess of, 20% of the number of shares of common stock outstanding before the issuance of the common stock or of securities convertible into or exercisable for common stock. Shareholder approval is not required under this rule if the common stock is sold in a private financing for cash, at a price at least as great as each of the book and market value of the issuer’s common stock.

Section 713 of the NYSE MKT Company Guide requires that an issuer obtain shareholder approval for a transaction involving (1) the sale, issuance, or potential issuance by the company of common stock (or securities convertible into common stock) at a price less than the greater of book or market value which, together with sales by officers, directors, or principal shareholders of the company, equals 20% or more of presently outstanding common stock; or (2) the sale, issuance, or potential issuance by the company of common stock (or securities convertible into common stock) equal to 20% or more of presently outstanding stock for less than the greater of book or market value of the stock.

Rule 5635 of the Nasdaq Marketplace Rules requires that an issuer obtain shareholder approval in connection with a transaction other than a public offering, involving: (1) the sale, issuance or potential issuance by the issuer, at a price less than the greater of book or market value, of common stock (or securities convertible into or exercisable for common stock) that, together with sales by officers, directors or substantial shareholders of the company, equals 20% or more of common stock or 20% or more of the voting power outstanding before the issuance; or (2) the sale, issuance, or potential issuance by the company, for less than the greater of book or market value, of common stock (or securities convertible into or exercisable for common stock) equal to 20% or more of the common stock or 20% or more of the voting power outstanding before the issuance.

Shareholder approval also may be required by the rules of the securities exchanges for a private placement completed in connection with an acquisition, or a private placement that results in a change of control, or a private placement involving related parties.

---

**Regulation FD and Other Legal Concerns**

**How does an issuer ensure that it has complied with Regulation FD in the context of conducting a PIPE transaction?**

An issuer is owed a duty of confidence from its agents, such as its placement agent, accountants, and other participants in the PIPE process. Generally, an issuer does not share any information with potential investors that has not already been included in the issuer’s Exchange Act reports.

A private placement memorandum for a PIPE transaction usually contains the issuer’s Exchange Act reports, together with legal disclaimers. It is prudent to limit the information contained in the private placement memorandum unless the issuer will be receiving signed confidentiality agreements. Although the issuer is not sharing material nonpublic information about its business with potential PIPE investors, the issuer is sharing its plans concerning a potential financing transaction. The fact that the issuer is contemplating a
PIPE transaction may itself constitute material nonpublic information. This will depend on the particular facts and circumstances. In any event, however, an issuer will not want to be forced to make a premature disclosure regarding a financing.

The issuer should ensure that, before the placement agent reveals the issuer’s name, the placement agent obtains an oral or written agreement from each potential purchaser it contacts that information shared will be kept confidential, and that agreement contains an explicit undertaking on the part of the potential purchaser to refrain from trading in the issuer’s stock.

Given that an issuer that is contemplating a PIPE transaction generally seeks to preserve its flexibility and only make a disclosure once definitive agreements have been executed, it is unlikely that an issuer will want to engage in any form of general solicitation, even if permissible.

**What must the placement agent do in order to comply with Regulation M?**

Most PIPE transactions are “distributions” for purposes of Regulation M. The placement agent must refrain from making a market in the issuer’s securities during the applicable Regulation M “restricted period.” Depending on the average daily trading volume of the issuer’s security, the restricted period for an agent participating in a PIPE transaction is either one or five days prior to the pricing (as opposed to the funding or closing of the transaction). The placement agent also must file a Regulation M notice with FINRA.

---

*What are the sources of the “primary” versus “secondary” offering questions that some issuers have received in connection with resale registration statements that have been reviewed?*

Certain issuers that have filed resale registration statements to cover the resale of shares originally offered in a PIPE transaction have received comments from the SEC questioning whether it is appropriate for the issuer to use a resale registration statement (rather than a primary registration statement) for those shares, particularly in the case of PIPE transactions involving convertible securities. This is especially the case for small cap issuers, as well as for issuers that have sold a disproportionately large number of shares in a PIPE, which has been understood to mean shares in excess of 33% of the total shares outstanding prior to the PIPE transaction.

In these cases, the SEC will take a look at the facts and circumstances of the issuance and the resale registration statement. The SEC will look at the factors it outlined in its 1997 interpretative guidance. Specifically, the SEC will consider: the amount of securities involved; how long the securities have been held; whether the investors are at market risk from the time they purchase the securities; the circumstances under which the securities were acquired; and whether it appears the seller is acting as a conduit for the issuer. Of course, to the extent the SEC is comfortable that the private placement was properly completed, the issuer can proceed with the use of the resale registration statement.

The SEC has said that in instances where it will not permit the resale registration statement to proceed, the issuer can cut back the number of shares and then file a
second resale registration statement for the shares that were cut back.

---

**Equity Lines of Credit, “Future-Priced” Securities, and Death Spiral or Toxic Converts**

**What is an equity line of credit?**

Under an equity line of credit, the company enters into an agency agreement with an investor pursuant to which the company has the right, during the term of the equity line and subject to certain conditions, to put its securities to the investor.

Some equity lines of credit are completed using a shelf registration statement and others are completed as private placements with an obligation to register the resale of the securities sold under the equity line.

**What is a “future priced” security?**

Future priced securities are convertible securities, often issued through a private placement or in a Regulation S offering. For example, death spiral or toxic converts are “future priced” securities. See “What is a death spiral or toxic convert?”

The conversion price or conversion ratio of the security is tied to a percentage discount to the market price of the underlying common stock at the time of conversion. As a result, the conversion price floats, or varies, based on the market price of the underlying common stock. The lower the market price at the time of conversion, the greater the number of underlying shares that will be issued upon conversion.

**What is a death spiral or toxic convert?**

The terms death spiral or toxic convert refer to a privately placed convertible security that has a floating conversion ratio, without a “floor.” The conversion ratio of the security adjusts based upon the market price of the company’s securities at some point in the future, usually at the time of conversion. Death spirals or toxic converts typically reset or adjust downward (to protect the investor) not upward (to protect the company).

Death spirals or toxic converts typically are priced at some discount to the company’s closing bid price over a period of days preceding the pricing date. This price can be manipulated easily. Generally, the securities are placed by a hedge fund, instead of a broker-dealer. These securities may have very dilutive effects on the company’s stock.

By Anna T. Pinedo, Partner, and James R. Tanenbaum, Partner, Morrison & Foerster LLP

© Morrison & Foerster LLP, 2016
**Summary Chart of Exempt Offering Alternatives**

Below we provide a summary comparison of various securities exemptions.

<table>
<thead>
<tr>
<th>Type of Offering</th>
<th>Dollar Limit</th>
<th>Manner of Offering</th>
<th>Issuer and Investor Requirements</th>
<th>Filing Requirement</th>
<th>Restriction on Resale</th>
<th>Blue Sky Exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Section 3(a)(11)</strong></td>
<td>None.</td>
<td>No limitation other than to maintain intrastate character of offering.</td>
<td>Issuer and investors must be resident in state. No limitation on number.</td>
<td>None.</td>
<td>Rests within the state (generally a 9-month period for resales within state pursuant to Rule 147).</td>
<td>Need to comply with state blue sky laws by registration or state exemption.</td>
</tr>
<tr>
<td><strong>Section 4(a)(2)</strong></td>
<td>None.</td>
<td>No general solicitation or general advertising.</td>
<td>Investors must meet sophistication and access to information test so as not to need protection of registration.</td>
<td>None.</td>
<td>Restricted securities.</td>
<td>Need to comply with state blue sky laws.</td>
</tr>
<tr>
<td><strong>Rule 504 Regulation D</strong></td>
<td>$1 million within prior 12 months</td>
<td>No general solicitation or general advertising unless registered in a state requiring use of a substantive disclosure document or sold under state exemption for sales to accredited investors with general solicitation.</td>
<td>Available to non-reporting companies only that are not investment companies or blank check companies.</td>
<td>File Form D with the Commission not later than 15 days after first sale.</td>
<td>Restricted unless registered in a state requiring use of a substantive disclosure document or sold under state exemption for sale to accredited investors with general solicitation.</td>
<td>Need to comply with state blue sky laws by registration or state exemption.</td>
</tr>
<tr>
<td><strong>Rule 505 Regulation D</strong></td>
<td>$5 million within prior 12 months</td>
<td>No general solicitation or advertising.</td>
<td>Unlimited accredited investors and 35 non-accredited investors.</td>
<td>File Form D with the Commission not later than 15 days after first sale.</td>
<td>Restricted securities.</td>
<td>Need to comply with state blue sky laws.</td>
</tr>
<tr>
<td><strong>Rule 506(b)</strong></td>
<td>None.</td>
<td>No general solicitation or general advertising under Rule 506(b).</td>
<td>Unlimited number of accredited investors and 35 non-accredited investors that are sophisticated.</td>
<td>File Form D with SEC not later than 15 days after first sale.</td>
<td>Restricted securities.</td>
<td>No need to comply with state blue sky laws.</td>
</tr>
<tr>
<td>Regulation</td>
<td>Tier 1 (Regulation A)</td>
<td>Tier 2 (Regulation A)</td>
<td>Regulation Crowdfunding</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>------------</td>
<td>----------------------</td>
<td>----------------------</td>
<td>------------------------</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rule 506(c)</td>
<td>None.</td>
<td>All purchasers must be accredited investors.</td>
<td>Under Rule 506(c), all purchasers must be accredited investors. Issuer must take reasonable steps to verify accredited investor status.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>File Form D with the SEC not later than 15 days after first sale.</td>
<td>File test-the-waters documents, Form 1-A, any sales material and report of sales and use of proceeds with the SEC.</td>
<td>Requires the preparation of a Form C, which resembles a Form 1-A.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Restricted securities.</td>
<td>Not restricted securities.</td>
<td>Securities sold in an offering are subject to certain transfer restrictions for one year.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No need to comply with state blue sky laws.</td>
<td>Subject to state blue sky laws regarding pre-offering review, filing, and anti-fraud.</td>
<td>No need to comply with state blue sky laws.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tier 1 (Regulation A)</th>
<th>Tier 2 (Regulation A)</th>
<th>Regulation Crowdfunding</th>
</tr>
</thead>
<tbody>
<tr>
<td>$20 million within prior 12 months, but no more than $6 million by selling security holders.</td>
<td>$50 million within the prior 12 months, but no more than $15 million by selling security holders.</td>
<td>Up to $1 million in a 12-month period.</td>
</tr>
<tr>
<td>“Testing the waters” permitted before and after filing Form 1-A. Sales permitted after Form 1-A qualified.</td>
<td>“Testing the waters” permitted before and after filing Form 1-A. Sales permitted after Form 1-A qualified.</td>
<td>Offering must be made solely through a platform.</td>
</tr>
<tr>
<td>Eligible issuer No investor requirement.</td>
<td>Eligible issuer No investor requirement; however, investors who are natural persons and are not accredited investors are subject to an investment limit.</td>
<td>Issuers that are not reporting companies, not funds, and not subject to disqualification.</td>
</tr>
<tr>
<td>Not restricted securities.</td>
<td>Not restricted securities.</td>
<td>Securities sold in an offering are subject to certain transfer restrictions for one year.</td>
</tr>
<tr>
<td>Subject to state blue sky laws regarding pre-offering review, filing, and anti-fraud.</td>
<td>Not subject to state blue sky laws regarding pre-offering review; however, subject to state blue sky filing and anti-fraud requirements.</td>
<td>No need to comply with state blue sky laws.</td>
</tr>
</tbody>
</table>
**Investor Criteria for U.S. Private Placements and Other Offerings**

### Summary Tables and Comparisons

#### Regulation D: Accredited Investors

- Banks and savings and loan associations.
- Registered brokers or dealers.
- Insurance companies.
- Registered investment companies, business development companies, small business investment companies.
- Employee benefit plans established by a state or its subdivision with assets exceeding $5 million.
- ERISA plans where the investment decision is made by a plan fiduciary, or if the plan has assets exceeding $5 million. (Or if a self-directed plan, investment decisions are made by accredited investors.)
- Private business development company under the Investment Advisers Act.
- Corporations and other entities with assets in excess of $5 million.

Source: Rule 501 of Regulation D.

#### Institutional Accredited Investor: Regulation D

This category is not a defined term in Regulation D. Instead, an offering document or agreement may limit sales of the applicable securities solely to the Regulation D accredited investor categories that are institutional in nature (i.e., to those described in Rule 501(a)(1), (a)(2), (a)(3) or (a)(7)). This limitation is imposed in Regulation D offerings when the offering participants do not want individuals to purchase securities in the offering.

#### Rule 144A: Qualified Institutional Buyers

- Any of the following, which owns and invests at least $100 million in securities of unaffiliated entities:
  - Insurance companies.
  - Registered investment companies (subject to special aggregation rules relating to fund families) or any business development company.
  - Licensed small business investment company.
  - Employee plan established by a state or a subdivision.
  - ERISA employee benefit plans.
  - Certain trust funds where the trustee is a bank or trust company, and where the participants are certain institutions.
  - Business development companies.
  - Corporations and other entities.
  - Registered investment advisers.

- Registered broker-dealers, acting for their own accounts or the accounts of other QIBs, that owns and invests at least $10 million in securities of unaffiliated issuers.
- Any entity, all the equity owners of which are QIBs, acting for its own account or the accounts of other QIBs.
- Any bank, savings and loan or non-U.S. bank or savings and loan that owns at least $100 million in securities of unaffiliated issuers that are not affiliated with it and that has an audited net worth of at least $25 million.

Source: Rule 144A(a).


- A U.S. institutional investor that has, or has under management, total assets in excess of $100 million (for purposes of determining the total assets of an investment company under this rule, the investment company may include the assets of the family of investment companies of which it is a part).
- A registered investment adviser that has total assets under management in excess of $100 million.
- Must be:
  - A registered investment company; or
  - A bank, savings and loan association, insurance company, business development company, small business investment company, or certain employee benefit plans; a private business development company (as defined in Rule 501(a)(2)); a 501(c)(3) entity; or a trust.

## Investor Criteria for U.S. Private Placements and Other Offerings

### Summary Tables and Comparisons

### Qualified Purchaser: Investment Company Act

- Any natural person who owns at least $5 million in investments.
- Any company that owns at least $5 million in investments and that is owned by or for 2 or more natural persons that are related (or foundations or trusts established for their benefit).
- Certain trusts established for the investors in the two prior bullets.
- Any person, acting for its own account or the account of other qualified purchasers, who owns and investment at least $25 million in investments.

*Source: Section 2(a)(51) of the Investment Company Act.*

### Knowledgeable Employee: Investment Advisers Act

- An executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the investment company or an affiliated management person.
- An employee of the investment company or an affiliated management person who participates in the investment activities of the investment company or its affiliates, provided that the individuals has performed these duties for at least one year.

*Source: Rule 3c-5 under the Investment Advisers Act.*

### Qualified Client: Investment Advisers Act

- A natural person or a company that has at least $1 million under the management of the investment adviser.
- A person or a company that investment reasonably believes either:
  - Has a net worth (together with a spouse) of more than $2.1 million (as of August 15, 2016); or
  - Is a “qualified purchaser” under the Investment Company Act.
- A natural person who is:
  - Part of the investment adviser’s management; or
  - An employee of the investment adviser who participates in the investment activities of such investment adviser, and has had such duties for at least one year.

*Source: Rule 205-3 under the Investment Advisers Act.*

### Eligible Contract Participant: Commodity Exchange Act

- Entities with more than $10 million in assets (or an entity guaranteed by such an entity).
- Individuals with at least $10 million invested (or $5 million if the individual is hedging).
- An entity with a net worth of at least $1 million that are hedging commercial risk.
- Financial institutions.
- Insurance companies.
- Registered investment companies and similar non-U.S. entities.
- Commodity pools with at least $5 million in assets under management.
- ERISA plans with assets of at least $5 million (or that have investment decisions made by a registered commodity pool adviser, commodity trading adviser or a financial institution or insurance company).
- U.S. federal, state and non-U.S. government entities.
- U.S. registered broker-dealers and similar non-U.S. entities.
- Futures commission merchants and similar non-U.S. entities.

*Source: Section 1a(18) of the Commodity Exchange Act.*
BEIJING
BERLIN
BRUSSELS
DENVER
HONG KONG
LONDON
LOS ANGELES
NEW YORK
NORTHERN VIRGINIA
PALO ALTO
SACRAMENTO
SAN DIEGO
SAN FRANCISCO
SHANGHAI
SINGAPORE
TOKYO
WASHINGTON, D.C.