

## What Are Pre-funded Warrants?

Pre-funded warrants are a type of warrant that allows its holder to purchase a specified number of a company's securities at a nominal exercise price. The nominal exercise price is typically as low as \$0.01 per share (often referred to as "penny warrants"). The term "pre-funded" refers to the structural feature that allows the company to receive, as part of the pre-funded warrant's purchase price, the exercise price that would be due for a traditional (not pre-funded) warrant, except for the nominal exercise price, at the time of the warrant's issuance instead of at the time of the warrant's eventual exercise.

A pre-funded warrant is typically exercisable, in whole or in part, at the holder's option immediately following its issuance and generally over a lengthy exercise period (as long as ten years) in order to provide the holder with desired ownership flexibility. However, a pre-funded warrant that expires unexercised has no further value and the purchase price of the pre-funded warrant paid by the holder at the time of the pre-funded warrant's issuance is not returned to the holder upon expiration. The different risk profile of a pre-funded warrant compared to a traditional warrant, due to the higher non-refundable purchase price and lower or nominal exercise price, should be adequately disclosed in the warrant's offering document.

Pre-funded warrants are generally issued as part of a larger financing transaction, such as a venture capital investment, minority equity investment, or mezzanine financing. The pre-funded warrant holder typically also invests in other types or classes of the company's securities, including its common stock, convertible securities, and traditional warrants, as part of or concurrent with the holder's acquisition of the pre-funded warrants.

## Why Use Pre-funded Warrants?

The purpose of using pre-funded warrants is to provide investors that have restrictions on their ability to own a company's securities above a designated ownership threshold (typically, 9.99% or 19.99%) with the opportunity to invest additional capital without violating the investor's ownership restrictions. A pre-funded warrant provides a holder with the flexibility to avoid exceeding the designated ownership threshold prior to the warrant's exercise while still maintaining the ability to immediately acquire the underlying securities at a nominal exercise price when the investor is ready to do so. Pre-funded warrants allow the company to receive almost all of the cash proceeds immediately upon the warrant's issue at a time when the company's underlying valuation is likely difficult to obtain or uncertain, instead of waiting until the warrant is exercised. Additionally, including the option to use pre-funded warrants in a transaction potentially expands the pool of prospective investors by resolving certain ownership concerns in certain circumstances.

The ability to delay ownership of a company's common stock is particularly important to holders that already hold or plan to acquire a significant percentage of a company's common stock. An investor with a significant ownership interest in voting securities of a company is likely to be considered an affiliate of the company. Further, in the absence of other large investors, a significant minority stake could cause an investor to be deemed a controlling shareholder, imposing upon it fiduciary duties to the company's other shareholders and requiring it to deal with the company at arm's-length. The federal securities laws impose numerous restrictions and limitations on affiliates and affiliate transactions, thus providing an incentive for investors to avoid affiliate status. The determination of affiliate status is a fact-specific analysis, but investors who hold more than 10% of an issuer's equity or otherwise have significant influence over management (including rights relating to the appointment of directors or officers) are frequently considered to be an "affiliate" of a company.

Of practical concern for potential affiliates, Rule 144 under the Securities Act of 1933, as amended, provides a safe harbor for public resales of a company's securities without having to register the resale with the Securities and Exchange Commission. There are five basic requirements of Rule 144, although not all requirements apply to every resale. Affiliates of a company must comply with all five requirements. However, investors who are not affiliates at the time of the sale, and have not been affiliates for the three months preceding the sale, must only comply with Rule 144's holding period and current public information requirements. As a result, investors are motivated to avoid affiliate status and take advantage of a less conditional Rule 144 safe harbor.

Due to these affiliate status concerns, certain investors have imposed ownership limitations that must be addressed prior to a capital investment. Pre-funded warrants can be a helpful supplement to an existing or proposed capital investment in

order to immediately provide the needed capital to the company while at the same time taking into consideration the investor's ownership concerns in advance.

### **How Are Pre-funded Warrants Structured?**

Similar to traditional warrants, pre-funded warrants are exercised by delivering a duly executed exercise notice to the company and paying the applicable exercise price. However, unlike traditional warrants, the exercise price is nominal and does not relate to the valuation of the company. Rather, the purchase price for the non-funded warrant and any other securities that are being purchased concurrently takes into account the valuation of the company at the time of issuance without future adjustment. As an alternative to payment of the nominal exercise price, the holder may elect to exercise the pre-funded warrant through a net share exercise, in which case the holder would receive upon such exercise the net number of shares of common stock determined according to the formula set forth in the pre-funded warrant. The holder of a pre-funded warrant, like a holder of a traditional warrant, does not have the rights or privileges of a holder of common stock, including any voting rights, until the holder exercises the pre-funded warrant.

Pre-funded warrants are typically structured to include anti-dilution protection. In traditional warrants, the exercise price is typically adjusted instead of the number of shares. However, with only a nominal exercise price, pre-funded warrants instead proportionally adjust the number of shares underlying the warrant following a specified change to the company's capitalization. Triggering events include a stock split, reverse stock split, merger, acquisition, or similar recapitalization or reorganization of the company.

Pre-funded warrants also generally include other anti-dilution provisions that protect the holder from a future issuance of equity or convertible securities (including additional pre-funded warrants) and also upon any significant distribution of company assets, including cash or other property, to shareholders. These anti-dilution provisions similarly adjust the number of shares issuable (instead of the exercise price) by the pre-funded warrant in the event that the company issues equity or convertible securities at a price below the fair market value of the company's common stock. The "weighted average" or "full ratchet" anti-dilution provisions that are commonly found in traditional warrants are not used in pre-funded warrants due to the pre-funded warrant's nominal exercise price. Given the restrictions imposed on the company's ability to raise capital, the anti-dilution provisions in pre-funded warrants are often a focus of negotiations between the company and the prospective holder.

In addition, pre-funded warrants typically include a fundamental change provision. Upon the occurrence of a fundamental transaction, such as a merger, acquisition, or similar reorganization, the holders of pre-funded warrants are generally entitled to receive the kind and amount of securities, cash, or other property that the holders would have received had they exercised the pre-funded warrants immediately prior to the occurrence of such fundamental transaction.

Finally, pre-funded warrants are generally not listed on any national securities exchange or automated quotation system. However, subject to applicable laws, pre-funded warrants may generally be transferred without the company's consent to non-affiliates.

### **20% Rule Considerations**

Generally, both the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market ("Nasdaq") require shareholder approval in connection with issuances of common stock, or securities convertible into or exercisable for common stock (such as pre-funded warrants), in a private offering equal to 20% or more of the common stock or voting power outstanding before the issuance. This is often referred to informally as the "20% Rule."

The purpose of the 20% Rule is to provide a company's shareholders with adequate notice and disclosure of a proposed private offering so that they might have an opportunity to sell their shares or vote on the proposed offering due to the potential dilutive nature of such a large offering. An offering of pre-funded warrants that are exercisable for 20% or more of a company's common stock has the potential to be dilutive to existing shareholders. Further, existing shareholders typically do not participate in a pre-funded warrant offering as the security is structured to meet and address the specific ownership concerns of the company's larger investor(s).

Nasdaq has indicated that it closely examines any offering that includes warrants that are exercisable for little or no consideration. Nasdaq may exercise its discretionary authority to object to a transaction involving warrants with a nominal exercise price, even when shareholder approval is not required. Issuers considering a transaction involving pre-funded warrants or other deeply discounted securities should consult Nasdaq before moving forward. The NYSE does not provide guidance on the evaluation of pre-funded warrants.

Pre-funded warrants that are included with common stock as part of a concurrent common stock or unit offering will also impact the total market value analysis for purposes of the 20% Rule if the total purchase price is below the greater of the company's market or book value. For instance, if the common stock portion of an issuance that includes pre-funded warrants is less than the 20% threshold and the shares and pre-funded warrants are offered together for below the greater of market or book value, but with the inclusion of the pre-funded warrant portion (assuming full exercise) the offering is greater than 20%, then the transaction will require shareholder approval.

### **Sample Pre-funded Warrant Language**

For reference, set forth below is sample language typically included in a pre-funded warrant:

#### Mechanics of Exercise

Subject to the terms and conditions hereof, this Warrant may be exercised by the Holder on any day on or after the Issuance Date (an "Exercise Date"), in whole or in part, by delivery (whether via facsimile or otherwise) of a written notice (the "Exercise Notice") of the Holder's election to exercise this Warrant. Within one (1) Trading Day following an exercise of this Warrant as aforesaid, the Holder shall deliver payment to the Company of an amount equal to the Exercise Price (as defined below) in effect on the date of such exercise multiplied by the number of Warrant Shares as to which this Warrant was so exercised (the "Aggregate Exercise Price") in cash or via wire transfer of immediately available funds if the Holder did not notify the Company in such Exercise Notice that such exercise was made pursuant to a Cashless Exercise (as defined below). The Holder shall not be required to deliver the original of this Warrant in order to effect an exercise hereunder. Execution and delivery of an Exercise Notice with respect to less than all of the Warrant Shares shall have the same effect as cancellation of the original of this Warrant and issuance of a new Warrant evidencing the right to purchase the remaining number of Warrant Shares. Execution and delivery of an Exercise Notice for all of the then-remaining Warrant Shares shall have the same effect as cancellation of the original of this Warrant after delivery of the Warrant Shares in accordance with the terms hereof.

#### Exercise Price

For purposes of this Warrant, "Exercise Price" means \$0.01 per Warrant Share, subject to adjustment as provided herein.

#### Cashless Exercise

Notwithstanding anything contained herein to the contrary, the Holder may, in its sole discretion, exercise this Warrant in whole or in part and, in lieu of making the cash payment otherwise contemplated to be made to the Company upon such exercise in payment of the Aggregate Exercise Price, elect instead to receive upon such exercise the "Net Number" of Warrant Shares determined according to the following formula (a "Cashless Exercise"):

$$\text{Net Number} = A - (A \times B)$$

For purposes of the foregoing formula:

A = the total number of shares with respect to which this Warrant is then being exercised.

B = \$0.01 (as adjusted for stock splits, stock dividends, stock combinations, recapitalizations, and similar events)

If the Warrant Shares are issued in a Cashless Exercise, the parties acknowledge and agree that in accordance with Section 3(a)(9) of the 1933 Act, the Warrant Shares take on the registered characteristics of the Warrants being exercised.

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