When a primary is not a primary

Large volumes of Pipe securities now cannot be easily sold on

There have been highly respected opponents of the view that the earth is round. Yet it always was, and always will be, round. Similarly, most corporate finance textbooks explain that, when an issuer sells its securities to an investor, it is, and always will be, a primary sale of securities. When that investor turns around and sells those securities to another investor, these textbooks explain that is a secondary sale of securities.

Pretty straightforward? Perfectly clear? Not exactly. Physicists have told us that the earth is mostly, but not perfectly, round. And the US Securities and Exchange Commission has informed us that, in certain circumstances, secondary offerings are primary offerings. The SEC has served notice that the textbook definitions of primary and secondary offerings might not necessarily capture the substance of a particular transaction. And for this reason the SEC has stated that the traditional approach for determining when primary or secondary registration requirements should apply is in need of some basic change.

The SEC has recently taken the position that, for certain issuers, a resale registration statement might not be available in connection with the registration of securities originally sold to investors in a Pipe (Private Investment in Public Equity). Several capital-raising techniques involving some element of a private financing by an already-public company are referred to as Pipes. In a traditional Pipe, investors contract to purchase an issuer's securities in a private placement and receive restricted securities. The issuer undertakes to file with the SEC a registration statement covering the investors' resale from time to time of those restricted securities. So investors obtain reasonable certainty of prompt liquidity.

The issuer typically would use a short-form, or Form S-3, registration statement to register the resale, even if the issuer would not be eligible to use that form for its primary offerings. To be eligible to use Form S-3 on a primary basis, an issuer must have a public float of at least $75 million (held by non-affiliates) and must not have been delinquent in its SEC filings and not have defaulted in certain of its payment obligations during the preceding 12 months. Although for now the SEC's position applies only to issuers that have a public float of less than $75 million, it raises a number of questions of broader application.

Historically, an issuer did not consider the magnitude of a completed and valid private placement when assessing the availability of a resale registration statement for its Pipe investors. For issuers that are not S-3 eligible on a primary basis, the SEC has said that a resale registration statement might not be available if the issuer sold a disproportionately large (relative to the issuer's pre-transaction total shares outstanding) number of securities in a Pipe. The SEC takes the view that the purported secondary offering could in fact be a primary offering, with the selling securityholders acting as underwriters that are selling their securities on the issuer's behalf. Registration statements in these circumstances contemplate that the selling securityholders will offer their securities from time to time at prevailing market prices, or in a continuous offering. However, an issuer must be S-3 eligible on a primary basis to register a continuous offering.

The SEC has raised concerns about Pipes in the past. In the mid-1990s, the SEC focused on the private aspect of the Pipe – was there a bona fide private placement? The SEC observed that many Pipes were completed at substantial discounts to the trading price of the issuer's common stock; that many Pipe purchasers were flipping their Pipe shares; and that many closing conditions had gradually been introduced in the documentation, which threatened the validity of the private placement exemption. The SEC clarified that the only acceptable conditions to closing are conditions whose satisfaction are outside the purchaser's control. In equity line transactions structured as private placements, the SEC required that disclosure be included in the related registration statement identifying issues relating to potential violations of Section 5 (the registration requirement) of the 1933 Act in connection with the private element of these transactions.

In its recent comments, the SEC has not requested similar language for Pipe registration statements. The SEC's comments do not question the availability of the private placement exemption, nor do they raise the possibility of a burst Pipe, or Section 5 violation. But the SEC has reasoned that, due to the magnitude of the original private placement, the purported secondary offering is in fact a primary offering – without any regard to the beneficiary of the proposed resale (or sale) of securities. To conclude that the selling securityholders were underwriters, one must assume that the selling securityholders must have been acting on the issuer's behalf in connection with the resale or sale of the securities they held. This suggests that the private placement and the subsequent sale of the Pipe securities were part of a single plan of financing that should have been structured as a registered transaction. The issuer only received proceeds from the initial private placement, and the issuer will not receive any proceeds from future sales by the selling securityholders pursuant to the registration statement of their restricted securities. If the private placement and the subsequent sales by the selling securityholders were, indeed, part of a single plan of financing for the issuer's benefit, it would make sense to question whether the private placement exemption would have been available in the first place.

In 1999, during the ascendancy of convertible Pipe transactions, the SEC staff reaffirmed support for the traditional Pipe structure – a private placement followed by the filing of a registration statement for the resale of the restricted securities. During this period, the SEC staff were focused on whether the Pipe investor bore market risk in respect of the restricted securities purchased in the Pipe. In a published interpretation, the SEC noted that it would "not object if a company registers the resale of securities prior to their issuance if the company has completed a Section 4(2)-exempt sale of the securities...to the investor, and the investor is at market risk at the time of filing of the resale registration statement. The investor must be irrevocably bound to purchase a set number of securities for a set purchase price that is not based on market price, or a fluctuating ratio, either at the time of effectiveness of the resale registration statement or at any subsequent date".

> "The SEC has informed us that, in certain circumstances, secondary offerings are primary offerings"

Outside of the Pipe context, the SEC applied a similar analysis in its review of forward equity recapitalization transactions undertaken by many Reits (Real Estate Investment Trusts) with derivatives dealers. In these transactions, the Reit issuer sold securities to the dealer in a private placement and entered into a contemporaneous forward sale contract, which was subject to price adjustment. In those transactions, the existence of a derivatives contract that mitigated market risk was seen as vitiating the private placement exemption, rendering the dealers underwriters.

As underwriters, the dealers could not avail of a resale registration statement for the restricted securities they had purchased from the Reit issuer. Consistent with this view, in 2001, the SEC provided additional guidance on equity lines of credit, many of which were structured as initial private placements to an investor or investor group. The SEC views equity lines as indirect primary offerings because equity line investors do not bear market risk. As a result, equity line investors must be identified as underwriters (as well as identified as selling securityholders) in the related registration statements. Although the SEC has never clarified how much market risk an investor must bear for the initial offering to be deemed a valid private placement, it is clear that if a countervailing transaction mitigates market risk for the investor, one must ask whether the investor should be characterized as an underwriter and whether the transaction should be characterized as a primary offering. In their analysis of Pipe transactions completed by smaller companies, where the SEC staff concluded that the offering by the selling securityholders was a primary offering, the staff have not focused much on the presence or absence of market risk.

The SEC also has begun looking closely at the hedging activities of Pipe purchasers. Hedge funds have become active Pipe purchasers. Their trading in close proximity to Pipes caught the attention of the SEC's enforcement area. In some cases, hedge funds have traded in advance of news of a Pipe being made public or in possession of other material non-public information. Other funds have engaged in manipulative trading practices, usually short selling, in connection with Pipes. The effect of these hedging activities could be aggravated in the case of transactions involving convertible securities with a variable conversion price. Although most of the regulatory inquiries and investigations have been led by the enforcement division, these hedging transactions have raised a number of questions similar to those discussed above. Is the hedging transaction a Section 5 violation? If a Pipe purchaser hedges the risk associated with its investment, has it retained enough market risk? Has the purchaser's countervailing transaction mitigated its investment intent? In its comments on Pipe resale registration statements, the SEC has been requesting additional details regarding the activities of the Pipe purchasers in the issuer's securities. It will be interesting to see whether the SEC will make assessments regarding the presence or lack of, or the extent and sufficiency of, market risk, or whether it will limit its inquiries to the nature of the purchaser's shorting or short-covering activities.

The SEC has reiterated that properly structured Pipe transactions are not problematic. For issuers seeking guidance regarding primary offerings and secondary offerings, the SEC has pointed to 1997 interpretative guidance in which it identified various factors that should be assessed in making this determination. These include: 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 in which the securities were acquired; the relationship between the selling securityholders and the issuer; whether the seller is in the business of underwriting securities; and whether it appears the seller is acting as a conduit for the issuer. This determination involves a case-by-case analysis of the facts and circumstances of each transaction. As a guidepost, and not a bright line test, the SEC has indicated that it will subject Pipe transactions resulting in the issuance of shares in excess of 33% of the issuer's pre-transaction total shares outstanding (held by non-affiliates) to closer scrutiny. The SEC might also subject transactions involving smaller share amounts but raising other concerns (based on the factors above) to more careful analysis. Similarly, transactions involving in excess of 33% of the issuer's pre-transaction float might not necessarily be deemed primary offerings – the decision will be based on the specific facts and circumstances, although size matters. In fact, of all of the factors that should be considered, offering size is the most significant.

"Hedge funds trading in close proximity to Pipes caught the attention of the SEC's enforcement"

That size matters so much is interesting. It harkens back to historic SEC views regarding presumptive underwriter status that had long since been repudiated. The emphasis on magnitude of an offering also runs counter to the SEC's view that an institutional investor's purchase of a large number of a registrant's securities made in the ordinary course of its business should not, on its own, result in the investor being deemed an underwriter.

The SEC staff also emphasized that they view transactions involving common stock and fixed price convertible securities as less problematic than transactions involving variable-priced securities. This is consistent with the views expressed in the late 1990s, as well as with their more recent hedging concerns. A structure involving variable-priced securities introduces the possibility of future dilution, and could invite shorting by investors in the Pipe, as well as third parties not participating in the transaction.

The SEC's views have a number of consequences. An issuer might not be able to comply with its obligations to have declared effective a resale registration statement within the required time and, as a result, might incur penalty payments in connection with any delays. Investors anticipating delays in obtaining liquidity might demand greater discounts in Pipe transactions for smaller companies. Transaction structures are likely to shift toward common stock sold at a discount, or fixed price convertible securities.

If a secondary offering (offering by selling securityholders) is recharacterized by the SEC as a primary offering, the selling securityholders will be deemed underwriters. Investors will have to be identified as underwriters (perhaps in addition to being identified as selling securityholders, as with equity lines) and will have the associated liability. The imperative to have an entity or series of entities responsible for the registrant's disclosure in a registration statement covering the resale (or sale) of a substantial number of the registrant's securities might actually be driving the SEC's analysis. Will this prompt better or more meaningful disclosure by issuers? The SEC has suggested that registration statements after Pipe transactions should include more details regarding payments made to financial intermediaries and the selling securityholders, details about any relationships among the selling securityholders and the registrant, and details regarding the securities issued or issuable, as well as the issuer's capitalization. Will these additional items, which one would think would otherwise already have been included by registrants attuned to the need for fulsome disclosure, change the overall mix of information available about a registrant? Are investors in transactions going to undertake additional diligence, or will transactions get restructured to obviate the issue? With its recent comments, the SEC has created a good deal of uncertainty and left many unanswered questions about its direction on primary and secondary offerings. Was it worth it for some incremental disclosure?

In the next year, we do not expect to learn much more about the shape of the earth. But we do expect to learn a lot more about how primary and secondary public offerings of securities will be executed in the US. The SEC has suggested that, as a means of easing these new burdens, it might consider other measures designed to improve the efficiency of the capital-raising process. The SEC has suggested that these could include lowering the thresholds for S-3 eligibility on a primary basis, as well as revising the criteria for use of Rule 415 for primary offerings. These would be welcome changes, but they would not clear up any of the confusion raised by recent analysis of primary and secondary offerings. In any case, this SEC initiative will have a profound impact on the ways in which US public companies raise capital.

By Anna T Pinedo and James R Tanenbaum of Morrison & Foerster