

# The offering of choice in 2008

## In a difficult US market, a registered direct combines the marketing appeal of private deals with the pricing of an underwritten public offering

**V**olatile capital markets make it hard for public companies to know how and when to access the capital markets. Financing windows open and close too rapidly for most companies to spot, let alone understand. Many have found it hard to access public markets, and the market for private financings is unpredictable and expensive.

A securities distribution methodology combining the marketing appeal and efficiency of private deals with the flexibility and pricing of an underwritten public offering may be the best response to the situation. A registered direct offering does exactly this.

### Testing the waters

Registered directs, or agency (best efforts) SEC-registered public offerings, are marketed principally to institutional investors. They have many elements in common with Pipes. Placement agents market them principally to institutional investors (like Pipes). An issuer with a shelf registration statement can conduct a registered direct quickly without incurring big costs. A registered direct may also be completed with a single-purpose (or bullet) registration statement if the issuer does not have or is ineligible for a shelf registration statement. Targeted marketing allows the issuer to test the waters without committing publicly to a deal.

A placement agent retained by an issuer that already has an effective shelf registration statement may engage in a non-deal roadshow or assess market

appetite for a financing without initially filing a prospectus supplement. The placement agent must then bring in compliance procedures that do not compel premature disclosure of the financing. It must ensure that potential investors are aware of the confidential nature of financing discussions. Even if the issuer and agent decide to file a preliminary prospectus supplement or a term sheet with a free writing prospectus, the filing of materials describing the contemplated transaction should not subject the issuer's stock to the short-selling often associated with the filing of an underwritten follow-on offering with a traditional marketing effort. The registered direct has the targeted or stealth marketing appeal and cost efficiencies associated with private placements and Pipes. It also offers the benefits of a registered deal. Investors receive registered stock, which is settled through the Depository Trust Company (DTC). Placement agents may allocate securities to retail investors and to mutual funds and pension funds that have limitations on their private securities holdings. Because registered directs do not present liquidity concerns (unlike Pipes), issuers obtain better pricing for their securities.

Although registered directs have existed for more than 20 years, a confluence of events has recently increased their role as the capital raising technique of choice. The prevalence of shelf registration statements and the ease of filing such registration statements, especially for well-known

seasoned issuers, since US securities offering reform, has made registered directs popular for larger issuers seeking to finance opportunistically and avoid the downward price pressure on their stocks that may accompany announcements of financings.

### Help for small firms

In December 2007, the SEC revised several rules. It shortened the Rule 144 holding period and eased the eligibility requirements for use of short-form registration statements on Form S-3 and F-3. An issuer with less than \$75 million in the public float will be able to register the sale of its securities (a primary offering) on Form S-3 or F-3 (for foreign private issuers), as long as it meets the other requirements of the relevant form, has not been a shell company for at least 12 calendar months before the filing of the form, has a class of common equity securities listed on a national securities exchange, and in a 12-month period does not sell more than the equivalent of one-third of its public float pursuant to that form. An issuer that meets the other eligibility requirements may use a short-form registration statement for secondary stock.

Before the amendments, an issuer needed a \$75 million public equity float to use the short-form registration statement forms for primary offerings. In a short-form registration statement, the issuer may incorporate by reference periodic reports filed after the effective date of the registration statement. There is no need to file post-effective amendments to reflect new business and financial developments. An issuer eligible to use Form S-3 may also conduct primary offerings off-the-shelf under Rule 415 of the 1933 Act. As a result of these changes, many smaller public companies will file kitchen sink or universal shelf registration statements (registering several classes of securities) so that they can offer their securities when the financing window opens. In the past, smaller public companies had limited financing options and were frequently restricted to private placements. A registered direct requires a smaller discount to the company's market price than a private placement or a Pipe.

### Pipe problems

Recent regulations have also affected Pipes. The SEC continues to bring enforcement actions against hedge funds and hedge fund principals for insider trading violations and market manipulation in connection with Pipes. It found that many hedge funds traded before news broke that a Pipe was

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made public. Many traded on other material non-public information, and others engaged in manipulative practices, usually improper short selling. In early 2007 the SEC's Division of Corporation Finance became concerned about micro-cap and smaller public companies conducting Pipes that substantially increased their total outstanding shares. The SEC issued comments challenging the availability of Form S-3 (for issuers that were then not eligible on a primary basis for the short-form registration statement) for the registration of the resale by selling security holders of the shares purchased in such Pipes. The SEC questioned whether those deals should be collapsed, or characterised as indirect primary offerings. In its original proposal on the changes to the S-3/F-3 eligibility requirements, the SEC expressed its concerns about practices regarding Pipes and the limited liquidity of many smaller public company stocks. The revised eligibility requirements partially reflect the SEC's desire to encourage smaller public companies to finance in the public markets, instead of relying on private placements and Pipes.

### Some limitations

Smaller public companies attempting to conduct private placements or Pipes often encounter the shareholder approval requirements of the securities exchanges – the 20% rule. Prior shareholder approval is needed for a private placement completed at a discount to the issuer's book value or market price a share, which may result in the issuance of 20% or more of the issuer's total outstanding capital stock. The shareholder approval requirements have limited the ability of smaller companies to raise enough funds, although they do not apply to bona fide public offerings.

The availability of shelf registration statements will enable more issuers to effect equity offerings without triggering the requirements. When properly structured and marketed, the securities exchanges will view registered directs as public offerings not subject to the limitations on issuance or requirement for shareholder approval associated with privates or Pipes. The one-third cap on issuances pursuant to the short-form registration statement may limit the financing options of smaller public companies.

### Public float limitation

In its June 2007 release, the SEC proposed that an issuer be permitted to sell up to 20% of its public float in primary offerings (newly issued shares) during any 12

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consecutive months. Commentators raised a number of objections to this 20% issuance cap. Many noted that, traditionally, the SEC had not used a disclosure statute, like the Securities Act, to address public policy concerns about trading volume and overall market liquidity, and therefore should not do so here.

Commentators also requested that the SEC reconcile this issuance cap with its recent comments in connection with Pipes suggesting that a resale registration statement would generally not be available to register the resale of the securities originally sold to investors in a Pipe, if those securities exceeded one-third of the issuer's public float. In the final rule changes, the SEC approved the adoption of a cap of one-third of an issuer's public float under a short-form registration statement, noting that this threshold will allow for an offering that is large enough to help an issuer raise a relatively large amount of capital when market opportunities arise. Issuers that seek to exceed this issuance cap would still be able to use other SEC forms, such as Form S-1 or Form F-1 or, alternatively, would be able to conduct exempt offerings.

The determination of the issuer's public float will be made immediately prior to the relevant time of sale, and may be based on any date in the 60 days prior to the proposed sale. The price of all securities sold under the form in the previous 12 months, whether debt or equity, including those securities to be sold in the proposed

sale, will be used to determine whether the issuer has exceeded the one-third cap. For securities that are convertible into, or exercisable for, equity securities, issuers must calculate the amount of securities that they may sell in any 12-month period by reference to the aggregate market value of the shares underlying the convertible securities, as opposed to the market value of the convertibles.

By calculating public float in this manner, an issuer's ability to use a shelf registration statement may increase or decrease during the life of the shelf registration statement, depending upon changes in the issuer's public float. Issuers that rely on these amended eligibility rules in order to use the short-form registration statement will need to set forth on the front cover of the relevant prospectus the amount of the public float, and the amount of securities offered in reliance on this rule.

The one-third cap will be removed if the issuer's public float increases to \$75 million after the effective date of the registration statement. If the issuer's public float falls below \$75 million at the time that the issuer files its next annual report, the cap will be reinstated. In contrast, issuers that satisfy the \$75 million threshold at the time the shelf registration statement is filed will not be subject to the one-third issuance cap, even if their public float falls below \$75 million after the effective date of the registration statement.

### An excellent opportunity

Large security holders that are affiliates of an issuer have found that registered directs often provide an excellent opportunity to sell shares into the public markets. They do not subject the issuer to the risks associated with an announced underwritten public offering of secondary shares or the market gyrations that accompany a series of sales pursuant to Rule 144.

In 2008 all market participants will be able to see the importance of registered directs.

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