

## Alternatives to Traditional Securities Offerings

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## **1. Introduction**

A traditional method of offering securities (as discussed in Chapters 1 and 2) may not be desirable or feasible due to challenging conditions in the capital markets or factors particular to an issuer. A variety of alternative methods, however, are available.

Among others, these variants include at-the-market equity offerings, block trades, private investments in public equity (“PIPE”) transactions, registered direct offerings and rights offerings. Capital raises through public investment vehicles, such as special purpose acquisition companies (“SPACs”) and business development companies (“BDCs”), also have become common in certain circumstances. In addition, other types of transactions, such as spin-offs and reverse mergers, are used by companies to achieve certain strategic corporate objectives.

This chapter discusses these alternatives and some of the principal federal securities law and related considerations they raise.<sup>1</sup>

## **2. At-the-Market Offerings**

### **2.1. Overview**

An at-the-market (“ATM”) offering is a public offering of equity securities into an existing trading market for outstanding shares of the same class at other than a fixed price.<sup>2</sup> An ATM offering typically is conducted under an “equity dribble-out,” or “equity distribution,” program under which the issuer takes advantage of its effective shelf registration<sup>3</sup> to sell its common stock into the market from time to time. The sales are transacted through one or more broker-dealers acting as the issuer’s agents, although programs often also allow the broker-dealers to act on a principal basis.

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<sup>1</sup> This chapter provides only an overview of these types of transactions, along with some of the related key legal considerations. Each type may raise additional legal or regulatory issues that, of course, should be considered with counsel well in advance.

<sup>2</sup> Rule 415(a)(4) under the Securities Act of 1933, as amended (the “Securities Act”).

<sup>3</sup> See Chapters 1, 3.

ATM offerings have been used since the early 1980s, particularly by issuers with predictable, ongoing capital requirements, such as utility, mining and energy companies. ATM offerings historically were less attractive due to restrictions on the amount of securities that could be sold and somewhat cumbersome mechanics relating to the identification of agents, as well as a requirement that sales be made on or through a national securities exchange or through a market maker. Elimination of these restrictions in 2005, combined with the effectiveness of an ATM program in raising capital during periods of equity market volatility, led to their use by a wider range of issuers.<sup>4</sup> The global financial crisis heightened the market's unpredictability, further broadening the appeal of ATM offerings.

## 2.2. Key Considerations

Because the securities are sold over a period of time in a piecemeal manner, rather than at once in a single offering, the timing, size and price of the individual issuances, or "takedowns," under an ATM program may be adjusted according to market demand and issuer preference. As a result, each takedown generally is less detrimental to the stock price than a traditional offering.

In addition, an ATM program may be less burdensome administratively for an issuer than a series of traditional offerings. Once the program has been established, the issuer is not required to renegotiate the terms for each offering and no special selling efforts are required—*e.g.*, road shows and investor meetings, which can be a significant drain on management's time. In addition, the agents' commission in an ATM program generally is significantly lower than the underwriting discount in a traditional underwritten follow-on offering.<sup>5</sup>

Despite these advantages, there are potential downsides that an issuer should consider. For an issuer looking to raise a substantial amount of capital in a short time and at a fixed price, dribbling into the market may well be insufficient. Also, although individual takedowns should be minimally disruptive, the establishment of the program itself could

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<sup>4</sup> In July 2005, as part of its Securities Offering Reform initiative, the Securities and Exchange Commission ("SEC") revised Rule 415 under the Securities Act to eliminate several restrictions regarding ATM offerings, including the limitation on the amount sold to 10% of the aggregate market value of the issuer's voting stock held by non-affiliates and the requirement that underwriters (*i.e.*, agents), if not already identified, be named in a post-effective amendment at the time of the offering. The revised rule also eliminated the requirement that sales be made through an underwriter acting as principal or agent on behalf of the issuer. These changes became effective December 1, 2005. *See* Securities Offering Reform, Securities Act Release No. 33-8591; Exchange Act Release No. 34-52056 (July 19, 2005); Securities Act Rule 415 (as amended Jan. 4, 2008); Securities Act Rule 415 (as amended Aug. 24, 1994)

<sup>5</sup> Of course, this difference in large measure reflects the nature of the risk being taken by the underwriters and agents in each case—*i.e.*, a firm commitment obligation to sell a comparatively large number of shares in the traditional context, as compared with a best efforts undertaking to dribble shares into the market in the ATM context.

create market “overhang” and have a negative effect on the stock price. Finally, as discussed further below, an ATM program requires due diligence by the agents during the life of the program, which imposes some administrative burden on the issuer.

### 2.3. Offering Process

The establishment of an ATM program generally is similar to the process required to carry out a traditional fixed-price underwritten public offering. The issuer enters into an equity distribution agreement<sup>6</sup>—which is like an underwriting agreement in a traditional offering—with one or more investment banks under which they agree to act as agents to sell the issuer’s equity securities into the trading market of the securities. Key differences arise from the continuing nature of the program and the existence of issuer discretion with respect to sales made under the program. The issuer is accordingly required to maintain an effective shelf registration statement, update the prospectus on an ongoing basis and give the agents notice with specific selling parameters for each takedown (*e.g.*, price, number of shares and timing). Additionally, the agents need to update periodically their due diligence regarding the issuer, so that offerings can be done without delay.

#### 2.3.1. Shelf Registration Statement

Offers and sales made pursuant to ATM programs are conducted pursuant to Rule 415(a)(4) under the Securities Act using an effective shelf registration statement. To do an ATM offering, an issuer must be eligible to use Form S-3 or Form F-3 on a primary basis. Accordingly, the use of ATM programs is generally limited to an issuer that has a public float of at least \$75 million, has been reporting under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), for at least 12 months and has timely filed its Exchange Act reports.<sup>7</sup> As discussed below, however, concerns arising under Regulation M typically limit ATM programs to issuers with a public float of at least \$150 million.

#### 2.3.2. Prospectus

A prospectus setting forth the terms of the equity securities offered and other information regarding the ATM program will be a part of the shelf registration statement. Together with the registration statement, the prospectus (and any

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<sup>6</sup> Equity distribution agreements are sometimes referred to as “sales agency agreements” or “distribution agency agreements.”

<sup>7</sup> In 2007, the SEC liberalized the eligibility requirements for Forms S-3 and F-3 for primary offerings to allow an issuer with a public float of less than \$75 million to use the forms, so long as, among other things, the aggregate market value of securities sold by the issuer in the offering and during the preceding 12 months did not exceed one-third of the issuer’s public float. *See* Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3, Securities Act Release No. 33-8878 (Dec. 19, 2007); Form S-3; Form F-3.

accompanying prospectus supplement) must provide detailed information about the ATM program, including the maximum size of the program (either by number of shares or aggregate gross proceeds) and the identities of the agents under the ATM program.<sup>8</sup>

As in any other public offering registered under the Securities Act, the information that has been conveyed to investors at the time of sale, not any information conveyed after that time, is the basis of any potential liability under section 12(a)(2) of the Securities Act.<sup>9</sup> Because sales made by agents under an ATM program generally are executed through securities exchanges or alternative trading systems where no direct communications with investors takes place, this information must be disseminated publicly to the market. To avoid offers and sales of securities while in possession of material non-public information, and to ensure that any potentially material information has been conveyed to potential investors before a takedown, the issuer typically will issue a press release, coupled with a filing on Form 8-K (for a domestic issuer) or Form 6-K (for a foreign private issuer),<sup>10</sup> which is incorporated automatically by reference into the program prospectus.<sup>11</sup> If the issuer is in possession of material non-public information that has not yet been disseminated to the market, it will suspend the use of the program so that no offers and sales are made until the information is disclosed.

Unlike a traditional underwritten public offering, sales under an ATM program typically are done in accordance with Rule 153 under the Securities Act, which provides that a broker-dealer (*i.e.*, an agent) effecting a transaction on a national securities exchange (or facility thereof), a trading facility of a national securities association or an alternative

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<sup>8</sup> During the life of the program, the issuer can amend the plan of distribution in the prospectus through a prospectus supplement (*i.e.*, without having to file a post-effective amendment). For example, agents can be added or removed, and a firm commitment underwritten offering can be conducted. *See* Securities Act Rule 430B(d).

<sup>9</sup> *See infra* note 42 for further discussion of section 12(a)(2).

<sup>10</sup> A corporation incorporated or organized under the laws of a foreign country is a “foreign private issuer” unless (A) more than 50% of its outstanding voting securities are directly or indirectly owned by residents of the United States and (B) (i) the majority of its executive officers or directors are U.S. citizens or residents, (ii) more than 50% of its assets are located in the United States or (iii) its business is administered principally in the United States. *See* Securities Act Rule 405.

<sup>11</sup> The number of shares that have been sold to date under the program and the net proceeds raised generally are not material in the context of a particular takedown. However, the issuer typically provides the market with this information each quarter in its Form 10-Q and Form 10-K (or Form 6-K and Form 20-F for a foreign private issuer), and sometimes also files a prospectus supplement with the same disclosure (perhaps out of an abundance of caution and a view to Rule 430B(h) under the Securities Act, which requires an issuer to file a prospectus supplement when material information about the securities offered is incorporated by reference from its Exchange Act reports).

trading system is deemed to have satisfied its prospectus delivery obligations if certain conditions are met.<sup>12</sup>

### 2.3.3. *Equity Distribution Agreement*

The equity distribution agreement sets out the terms and conditions on which the issuer and the agents will conduct offerings under the ATM program, including the parameters the issuer may set in instructing the agents to make sales, the extent of the agents' discretion in making sales and the agents' commission.<sup>13</sup> The equity distribution agreement typically terminates on a fixed date or when the maximum aggregate amount to be sold under the program is reached.

Equity distribution agreements contain provisions that are similar to those in an underwriting agreement for a traditional underwritten public offering, including customary representations and warranties and covenants by the issuer, certain conditions to offerings under the program and indemnification provisions. Because an agent in an ATM program will be considered an "underwriter" for purposes of the Securities Act, the agreement generally provides the agents the same protections that an underwriter in a traditional underwritten offering would receive. These provisions are designed to assist the agents in establishing a due diligence defense.

Accordingly, like a standard underwriting agreement, the equity distribution agreement requires the delivery of legal opinions and negative assurance, or "10b-5," letters from counsel, "comfort letters" from the issuer's independent auditors and other ancillary supporting documents at the time of establishment of the ATM program, as well as periodic updates to these deliverables, as discussed further below.

### 2.3.4. *Ongoing Due Diligence*

One of the most significant differences in the offering process under an ATM program is the ongoing due diligence process undertaken by the agents throughout the life of the program. For the issuer to most effectively utilize an ATM program, the agents should be positioned to conduct a takedown upon request of the issuer (subject to customary restrictions during trading blackout periods). The issuer therefore agrees to provide the opportunity for the agents to carry out periodic supplemental due diligence. Although

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<sup>12</sup> The key conditions, which should be satisfied in the context of an ATM program, are that: (i) securities of the same class as the securities that are the subject of the transaction are trading on the exchange, facility or system; (ii) the registration statement relating to the offering is effective and is not the subject of any stop order or related proceeding; and (iii) the issuer has filed or will file a prospectus that satisfies section 10(a) of the Securities Act. *See* Securities Act Rule 153(b).

<sup>13</sup> The equity distribution agreement also usually contains mechanics under which the issuer may agree with the agents that they will act as principal (*i.e.*, on a firm commitment, rather than best efforts, basis), in which case a supplemental agreement known as a "terms agreement" is entered into by the parties.

the specifics of the ongoing due diligence process differ among ATM programs, a program generally provides that the issuer will: (i) be deemed to repeat its representations and warranties in connection with each takedown; (ii) provide bring-down comfort letters, legal opinions and negative assurance letters on a quarterly basis; (iii) provide additional supporting documents, such as officer's certificates and other relevant materials, at least quarterly; (iv) make management available for due diligence sessions at least quarterly; and (v) provide the foregoing documents or make management available from time to time to the extent requested by the agents.<sup>14</sup>

### *2.3.5. Announcement and Execution of Sales*

A takedown generally does not involve marketing efforts associated with traditional underwritten public offerings, such as a road show or investor meetings. Special selling efforts also may be avoided with a view to a takedown not being deemed a "distribution" under Regulation M, as discussed below. The issuer, however, typically will make a public announcement regarding the establishment of an ATM program via press release in order to advise the market of its capital raising plan, which could well be material information.

By contrast, the number of securities sold in any single takedown generally is not significant relative to the public float or daily trading volume of the securities or otherwise. In accordance with the parameters set by the issuer, the agents execute sales through ordinary transactions on securities exchanges or through alternative trading facilities at the then-prevailing market prices.<sup>15</sup> At the end of the day, the agents are typically required to report to the issuer the number of shares sold, gross proceeds and related commissions. Settlement usually occurs on a T+3 basis unless otherwise agreed, as is the case in a traditional underwritten public offering.

## **2.4. Legal and Regulatory Considerations**

### *2.4.1. Regulation M*

Regulation M under the Exchange Act aims to strengthen the integrity and fairness of the securities markets by regulating potentially manipulative practices by participants in securities offerings. Rules 101 and 102 of Regulation M generally prohibit issuers,

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<sup>14</sup> In practice, issuers often are asked to provide officer's certificates and to participate in update due diligence calls more frequently. These steps may be agreed orally at the outset of an ATM program, instead of being set forth in the equity distribution agreement. Agents also might seek supplemental due diligence in connection with particularly noteworthy developments affecting the issuer or its sector.

<sup>15</sup> The elimination of the requirement to carry out ATM offerings on or through a national securities exchange or through a market maker may be particularly significant given the rise of so-called "dark pools," which now capture a substantial portion of trading volume in many securities listed on the New York Stock Exchange ("NYSE") and NASDAQ Stock Market ("NASDAQ").

distribution participants and their affiliated purchasers from directly bidding for, purchasing, or attempting to induce another person to bid for or purchase a “covered security”<sup>16</sup> during the applicable restricted period in respect of a distribution.<sup>17</sup> If takedowns under an ATM program could be deemed “distributions” under Regulation M, absent an exception, the agents effectively would be prohibited from trading the securities during the life of the program—*e.g.*, engaging in market-making or other ordinary course broker-dealer trading—given the potential for a takedown each day.<sup>18</sup>

Regulation M defines a “distribution” to be an offering “distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.”<sup>19</sup> The SEC has indicated that ordinary trading transactions into an independent market not involving special selling efforts generally will not be considered a “distribution.” “Unusual transaction-based” compensation for the agents, however, may alter that conclusion.<sup>20</sup> Accordingly, agents generally will not participate in ATM programs unless the securities fall within the “actively traded securities” exception from the Regulation M restrictions. Under this exception, the Regulation M restrictions do not apply to the agents<sup>21</sup> if the securities have worldwide “average daily

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<sup>16</sup> Regulation M defines a “covered security” as “any security that is the subject of a distribution, or any reference security.” Regulation M Rule 100. A “reference security” is “a security into which a security that is the subject of a distribution (‘subject security’) may be converted, exchanged or exercised or which, under the terms of the subject security, may in whole or in significant part determine the value of the subject security.” *Id.*

<sup>17</sup> In an ATM offering, the restricted period commences one or five business days before the pricing of each sale and continues until each agent’s participation in the distribution is complete. Anti-manipulation Rules Concerning Securities Offerings, Securities Act Release No. 33-7375; Exchange Act Release No. 34-38067 (Dec. 20, 1996).

<sup>18</sup> An issuer also will be restricted under Rule 102 of Regulation M, but typically will not be engaged in trading its own securities on a daily basis.

<sup>19</sup> Regulation M Rule 100(b).

<sup>20</sup> Anti-manipulation Rules Concerning Securities Offerings, Securities Act Release No. 33-7375; Exchange Act Release No. 34-38067 (Dec. 20, 1996). (“A broker-dealer likely would be subject to Rule 101, however, if it enters into a sales agency agreement that provides for unusual transaction-based compensation for the sales, even if the securities are sold in ordinary trading transactions.”).

<sup>21</sup> *See* Regulation M Rule 101(c)(1). Rule 102, which applies to issuers, limits an issuer’s ability to conduct transactions relating to the securities that are subject of the ATM program, though the issuer still would be able to engage in activities involving its other securities—*e.g.*, repurchasing convertible debt securities in the market.

Rule 100 of Regulation M defines “ADTV” (*i.e.*, average daily trading volume) as “worldwide average daily trading volume during the two full calendar months immediately preceding, or any 60 consecutive calendar days ending within the 10 calendar days preceding, the filing of the registration statement; or, if there is no registration statement or if the distribution involves the sale of securities on a delayed basis pursuant to [Rule 415 under the Securities Act], two full calendar months immediately preceding, or any consecutive 60 calendar days ending within the 10 calendar days preceding, the determination of the offering price.”

trading volume” of at least \$1 million and the issuer has a “public float value” of at least \$150 million.<sup>22</sup>

#### 2.4.2. *Publication and Dissemination of Research Reports*

If an agent (or its affiliate) already provides research coverage regarding the issuer, it should be able to continue doing so during the life of an ATM program pursuant to the safe harbor provided by Rule 139 under the Securities Act. The rule provides that research reports about an issuer or its securities will not be deemed offers for purposes of the registration provisions of the Securities Act so long as certain conditions are met. The research reports must be published by the agent in the regular course of its business and the publication must not be the initiation of coverage by the agent (or the reinitiation following discontinued coverage). The issuer must be eligible to use Form S-3 or Form F-3 to offer its securities, which should be the case for an ATM issuer, and meet certain other criteria.<sup>23</sup>

In addition to restrictions on research imposed by the Securities Act, other regulations, including NASD Rule 2711(f) of the Financial Industry Regulatory Authority (“FINRA”), may restrict research-related activities of the agent or its affiliates during the course of an ATM program. FINRA generally prohibits its members from publishing a research report on an issuer for which the member acted as manager or co-manager of a follow-on offering for 10 calendar days following the date of the offering. However, this restriction does not apply to research that complies with Rule 139 for an issuer with “actively-traded securities” as defined in Regulation M.<sup>24</sup> As discussed above, ATM

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With respect to “public float value,” Rule 100 of Regulation M indicates that it “shall be determined in the manner set forth on the front page of Form 10-K . . . even if the issuer of such securities is not required to file Form 10-K, relating to the aggregate market value of common equity securities held by non-affiliates of the issuer.”

<sup>22</sup> Additionally, Rule 104 of Regulation M prohibits both the issuer and the agents from engaging in stabilization activities with respect to the securities sold in an ATM offering, and agents are prohibited from passive market-making on NASDAQ during an ATM offering pursuant to Rule 103 of Regulation M.

Purchasers of securities in an ATM offering (other than a firm commitment takedown, which is rare) will be exempt from Rule 105 of Regulation M, which prohibits purchasers from covering certain short sales using securities purchased in an SEC-registered firm commitment offering for cash. Regulation M Rule 105(c).

<sup>23</sup> Rule 139 would not be available for a non-investment grade issuer that does not have a \$75 million public float. *See* Securities Act Rule 139(a)(1).

<sup>24</sup> Rule 101 of Regulation M also excepts from its restrictions research reports published pursuant to Rule 138 or Rule 139. Of course, if the subject securities are “actively-traded securities” within the meaning of Regulation M, the restrictions of Rule 101 would not apply to the agents.

programs generally will satisfy this requirement.<sup>25</sup> Investment banks also may impose additional restrictions on research under their internal policies for prudential purposes.

### 2.4.3. *Other*

In addition to complying with the federal securities laws, issuers and agents participating in an ATM program also must comply with applicable regulations and requirements of other regulatory bodies, including FINRA (*e.g.*, filings and approval or exemption therefrom with respect to the related shelf registration statement)<sup>26</sup> and the applicable securities exchange (*e.g.*, relevant listing requirements).

U.S. state “blue sky” laws regulating sales of securities generally should be preempted by U.S. federal securities laws because equity securities sold under ATM programs are listed on a U.S. national securities exchange.<sup>27</sup>

## 3. **Block Trades**

### 3.1. **Overview**

A block trade is a placement of a large block of equity securities by an issuer or selling securityholder.<sup>28</sup> Unlike traditional underwritten registered offerings, the underwriter typically commits to purchase the block at an agreed price without having conducted a bookbuilding process to gauge market demand. For this reason, block trades sometimes are referred to as “bought deals.”

The structure of a block trade provides significant benefits for the issuer or the selling securityholder by mitigating execution risk. The net proceeds are guaranteed before the offering is launched. This certainty generally comes at a cost, however, requiring the issuer or selling securityholder to accept a greater discount to the prevailing market

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<sup>25</sup> “Emerging growth companies,” or “EGCs,” also are not subject to the research report restrictions of NASD Rule 2711(f). See NASD Rule 2711(f)(5). For further detail on EGCs, see *infra* note 115.

<sup>26</sup> FINRA Rule 5110 generally imposes a filing and approval requirement for a shelf registration statement on Form S-3 or Form F-3 where the issuer does not satisfy the requirements for the use of those forms that applied in 1992. For further detail, see *infra* Section 3.4.2.

<sup>27</sup> See Securities Act § 18.

<sup>28</sup> The term “block trade” sometimes is used colloquially to refer to an accelerated offering of securities, even if a traditional bookbuilding exercise is conducted before the underwriters commit to purchase the securities. This discussion addresses the special concerns raised by the traditional concept of a block trade, or “bought deal.”

The discussion also focuses principally on a primary offering by an issuer, rather than a secondary offering by a selling securityholder. Generally the same considerations are present. The selling securityholder often is entitled to require the issuer to facilitate a sale on its behalf through registration rights acquired by the selling securityholder at the time of its investment in the securities.

price. In addition, there is substantial timing pressure on all parties to execute the transaction very quickly because the underwriter will seek to eliminate its risk by placing the securities as soon as possible. Accordingly, it is important that all parties are well-prepared in advance of the transaction.<sup>29</sup>

### 3.2. SEC-Registered Blocks

An SEC-registered block is typically conducted as a takedown off of the issuer's effective shelf registration statement. Unlike a traditional underwritten offering, the issuer or selling securityholder in a block trade often selects an underwriter through a bid process. The use of this process reflects the predominance of price as a factor in selecting an underwriter and helps mitigate the cost of achieving execution certainty by using the block trade structure.

Potential underwriters typically are informed of the contemplated block trade and invited to bid, while also being given a brief window for due diligence, as discussed further below. In most cases, the winning underwriter will be selected and the price for the block trade will be agreed to immediately after the close of trading (4:00 p.m. New York City time), following which the underwriter will begin reselling the securities to investors. Ideally, the resale of the securities by the underwriters will be completed by the open of trading the next day (9:30 a.m. New York City time).

The fact that an equity offering is being contemplated through a block trade itself may well be considered material non-public information, depending on a number of issuer- and offering-specific factors, including the size of the block relative to the issuer's public float, the securities' average daily trading volume and whether the offering is to be made by the issuer or a selling securityholder. Accordingly, to prevent potential investors from trading on the basis of material non-public information and to avoid violations by the issuer of Regulation FD's prohibition on selective disclosure, the issuer usually publicly announces the launch of the block trade before the underwriter approaches any potential investors about the offering (although limited pre-marketing efforts may be possible in certain cases as discussed below).<sup>30</sup> A selling securityholder in a secondary block trade generally will do the same.<sup>31</sup>

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<sup>29</sup> In March 2008, the Securities Industry and Financial Markets Association published "Block Trade Guidelines" that outline the major steps of the offering process in an SEC-registered block trade. The guidelines emphasize that execution in the block trade context is much quicker than in a typical traditional underwritten offering and that speed is critical to the success of the trade.

<sup>30</sup> The SEC adopted Regulation FD in 2000. It prohibits U.S. issuers from selectively disclosing material non-public information to market professionals and to securityholders under circumstances in which it is reasonably foreseeable that the holders will trade on the basis of the information. Whenever an issuer intentionally discloses material non-public information, it must do so through a general public disclosure, and whenever an issuer learns that it has made a non-intentional selective disclosure, it must make public disclosure of that information promptly. Regulation FD does not apply to foreign private issuers, but foreign private issuers nonetheless avoid

### 3.2.1. Shelf Registration Statement

The issuer must have an effective shelf registration statement on Form S-3 or Form F-3 with sufficient availability to conduct the block trade off the shelf. If the issuer is a well-known seasoned issuer (a “WKSI”),<sup>32</sup> it will have additional flexibility in this regard because the issuer will be able to file an immediately effective registration statement on Form S-3 or Form F-3 if a shelf registration statement is not already on file.<sup>33</sup>

### 3.2.2. Due Diligence

A registered block trade is subject to the same disclosure requirements and liability concerns as a traditional underwritten registered offering of equity securities. Therefore, despite the time pressure imposed on the offering process, the issuer and the underwriter will need to ensure the accuracy and completeness of the disclosure prior to pricing the offering.

Any additional information that needs to be conveyed to investors with respect to the offering, including any material developments relating to the issuer’s business, will typically be reflected in a press release, which also would be filed on a Form 8-K (for a domestic issuer) or a Form 6-K (for a foreign private issuer), as well as in the preliminary prospectus supplement used to market the offering.<sup>34</sup>

Because there is very limited time for the potential underwriters to perform due diligence, management and auditor due diligence sessions typically are conducted by

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selective disclosure of material non-public information due to concern for potential liability under Rule 10b-5 and as a matter of best practice.

<sup>31</sup> See FINRA Rule 5270 (addressing front running of block trades).

<sup>32</sup> The Securities Offering Reform introduced the WKSI concept. Among other benefits, a WKSI is entitled to automatic effectiveness for its shelf registration statements, facilitating greater access to the public capital markets. Rule 405 under the Securities Act defines “WKSI.” In general, a WKSI is a company that (i) on the determination date, meets the registrant requirements of Form S-3 or F-3, including having timely filed its Exchange Act reports for the preceding 12 calendar months, and (ii) within 60 days of that determination date either (1) has a worldwide market value of its voting and non-voting common equity held by non-affiliates of at least \$700 million or (2) (x) has issued in the preceding three years at least \$1 billion aggregate principal amount of registered non-convertible securities, other than common equity, in primary offerings for cash and (y) registers only non-convertible securities, other than common equity (unless the issuer also meets the \$75 million public float requirement of Form S-3 or F-3, in which case registration of common equity is permitted). See Securities Offering Reform, *supra* note 4, at 32-33, 228.

<sup>33</sup> A WKSI is also able to take advantage of the “pay-as-you-go” provisions of Rules 456(b) and 457 under the Securities Act to delay payment of its registration fees, which can help facilitate speedy execution.

<sup>34</sup> If there are no material developments to convey to investors, it may be possible to market the offering using just the disclosure in the base prospectus and any existing updates thereto (*e.g.*, through periodic and current reports incorporated by reference therein).

way of a group phone call with the prospective underwriters while they prepare their bids.<sup>35</sup> It also is standard for the issuer to have engaged designated underwriter's counsel prior to putting out the bid. Underwriter's counsel will have participated in structuring the offering with the interests of the underwriter in mind and done traditional documentary due diligence. Underwriter's counsel is thus positioned to assist the prospective bidders on structure and due diligence points during the compressed timeframe of the bid process. Underwriter's counsel also typically will be prepared to render a 10b-5 letter to the winning bidder, and the issuer's auditing firm will stand ready to deliver traditional comfort letters to the winner.

Of course, the extent of due diligence required to reach a level of comfort acceptable to the prospective underwriters generally will depend on their familiarity with the issuer and quality of information in the market regarding the issuer, such as the issuer's Exchange Act filings and research coverage.

### 3.2.3. *Selling Securityholders and Disclosure*

In the context of a block trade by an affiliate selling securityholder, the underwriter usually will seek a "clean hands" representation stating that the selling securityholder is neither in possession of nor making its decision to sell the securities on the basis of any material non-public information. If the affiliate selling securityholder is in possession of material non-public information, the issuer could make appropriate disclosure in advance of the offering. However, this may not work in practice if the issuer is reluctant to publicly disseminate the information—*e.g.*, because the issuer does not yet have a disclosure obligation regarding the information and is reluctant to disclose it prematurely.<sup>36</sup> In this case, the affiliate may have to delay its sale of the securities.<sup>37</sup> To

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<sup>35</sup> To protect the integrity of the bid process, special measures may be implemented to prevent the potential bidders from identifying each other—*e.g.*, questions for management may be passed offline through a representative of the issuer.

<sup>36</sup> In contrast to the securities laws of many other jurisdictions, the U.S. federal securities laws do not impose a continuous obligation to disclose material information. Absent the obligation to file a periodic or current report under the Exchange Act (*e.g.*, a Form 10-Q, Form 10-K, Form 8-K, Form 20-F or Form 6-K) or (for a domestic issuer) a proxy statement in connection with a shareholder meeting, the timing of disclosure of material information generally is up to the issuer. (NYSE and NASDAQ rules do require prompt disclosure of material information. *See* New York Stock Exchange, Listed Company Manual §§ 202.01, 202.05, *available at* <http://nysemanual.nyse.com/LCM/Sections/> (last updated Jan. 11, 2013) [hereinafter NYSE Listed Company Manual]; NASDAQ OMX, NASDAQ Stock Market Rules, Rule 5250(b)(1), *available at* <http://nasdaq.cchwallstreet.com/> (last updated Jan. 23, 2013) [hereinafter NASDAQ Stock Market Rules]. However, they do not have the force of law and do not give rise to a private right of action. *See* State Teachers Ret. Bd. v. Fluor Corp., 654 F.2d 843, 852 (2nd Cir. 1981).) Of course, if a person chooses to make an offer or sale of securities, failure to disclose material non-public information can result in criminal and civil liability under the securities laws.

<sup>37</sup> It is common for the registration rights agreement under which the selling securityholder has the right to use the shelf registration statement for the block trade to allow the issuer to impose this sort of delay.

further mitigate this risk, as well as generally to help ensure the adequacy of disclosure, it is common for block trades—both by the issuer and selling securityholders—to be timed to occur just after the issuer’s earning release or filing of a periodic report.

### 3.2.4. *Fixed vs. Variable Price Reoffer*

Because there is very little time to market the resale of the securities after launch, it may be challenging for the underwriter to determine a single, fixed price at which to resell the entire block. Accordingly, the underwriter may prefer to offer securities to investors at a variable, instead of fixed, price. If the block trade is structured on a variable price reoffer basis, the offering documents will disclose that the underwriter will reoffer the securities from time to time at market prices or at negotiated prices that may vary.<sup>38</sup>

### 3.2.5. *Limited Premarketing*

Although most bid processes for a registered block trade will not afford the underwriter a meaningful opportunity to engage potential investors prior to the submission of its bid, in some cases a prospective underwriter may be able to engage in limited pre-marketing activity prior to submitting its bid (and before the launch of the offering is publicly announced). Where there is sufficient time between when the block trade is put out to bid and when the bid is due, potential underwriters may seek to manage the risk of winning the bid and committing to buy the securities by contacting potential investors to gauge market demand. The issuer generally prefers to limit these activities in order to minimize the risk of a leak and resulting pressure on its stock price before it agrees to sell its securities. However, pre-marketing may nevertheless be permitted so long as it is conducted in a manner that does not offend the registration requirements of the Securities Act and takes into account insider trading and Regulation FD considerations.

In the context of a registered block trade, oral offers to sell securities may be made only if a registration statement covering the offered securities is on file with the SEC—a requirement that should be satisfied in the context of block trade off a shelf registration statement that is on file.<sup>39</sup> The fact that the issuer is planning the block trade is in itself

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<sup>38</sup> It is customary to issue a pricing press release in most types of deals, including traditional firm underwritten offerings. In a variable price block trade, a pricing press release would be unusual because there is no single price to the public. In a fixed price block trade, a pricing press release often is issued and, in some cases, for a NYSE-listed issuer, NYSE may insist on a release if it considers the underwriting discount or the price to the public material. This issue should be discussed with counsel and, when appropriate, NYSE.

In some cases, the underwriting discount will reflect not only a discount to the market at the time of launch, but also the price at which the securities are sold to the public.

<sup>39</sup> Although Rule 163 under the Securities Act permits a WKSI to make unrestricted oral and written offers relating to its own securities before a related registration statement is filed, this exemption does not extend to underwriters.

very likely to be material non-public information. If this is the case or if any other material non-public information is to be shared, it is critical that any discussion with potential investors be done only by way of a “wall-crossing” procedure. Under this procedure, potential investors agree to keep the information confidential until the offering is publicly announced or until a specified date, following which the issuer will have abandoned the offer and any material non-public information shared with the potential investors either will have been disclosed or ceased to be material.<sup>40</sup>

### 3.3. Exempt Block Trades

In certain circumstances, which generally do not include primary offerings by listed U.S. issuers, a block trade also may be conducted pursuant to an exemption from registration under the Securities Act—*e.g.*, Rule 144, Rule 144A and Regulation S. By avoiding the need for an effective registration statement, an unregistered trade may require less lead time and involve lower costs than a registered block trade. An unregistered block typically is done on an undocumented basis and—while generally subject to section 10(b) of, and Rule 10b-5 under, the Exchange Act<sup>41</sup>—is not subject to the higher standards of liability that attach to registered offerings under sections 11 and 12(a)(2) of the Securities Act.<sup>42</sup> Due to the absence of an offering document, the purchase agreement for an unregistered block trade typically contains only limited representations and warranties (*e.g.*, relating to ownership of securities and non-possession of material

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<sup>40</sup> See Rule 100(b)(2)(ii) of Regulation FD, which excludes from the prohibition on selective disclosure information shared with a person “who expressly agrees to maintain the disclosed information in confidence.” *See infra* note 85.

<sup>41</sup> The Supreme Court recently has limited substantially the extraterritorial applicability of section 10(b) of the Exchange Act and Rule 10b-5 thereunder in private rights of action. *See Morrison v. Nat’l Austl. Bank*, 130 S. Ct. 2869 (2010). In *Morrison*, the Court held that section 10(b) did not provide a cause of action for foreign plaintiffs who purchased securities on a foreign exchange because the securities were listed only on a foreign exchange and “all aspects of the purchases . . . occurred outside the United States.” *Id.* at 2888. The Court established a new “transactional” rule that section 10(b) only reaches “transactions in securities listed on domestic exchanges, and domestic transactions in other securities.” *Id.* at 2884. Despite this ruling, as discussed below, investment banks nonetheless proceed cautiously in the context of Regulation S-only undocumented transactions, motivated generally by concerns for reputational risk, as well as securities law liability under non-U.S. securities laws.

<sup>42</sup> Section 11 imposes liability on the issuer, underwriters and specified other persons if any part of the registration statement (including the prospectus), at the time it becomes effective, includes “an untrue statement of a material fact or omit[s] to state a material fact necessary in order to make the statements therein not misleading.” Section 12(a)(2) provides that any person who offers or sells a security “by means of a prospectus or oral communication” that contains a material misstatement of a material fact, or fails to state a material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading, is liable to the purchaser for damages.

By contrast, section 10(b) and Rule 10b-5 require a showing of *scienter*—*i.e.*, knowing violation or at least recklessness—which is a more difficult standard for a plaintiff to meet than under sections 11 or 12(a)(2).

non-public information) and covenants (*e.g.*, relating to information furnishing and filing of Form 144, if applicable), and in certain cases a more limited indemnity.

Despite the absence of a registration statement and thus the related liability provisions of the securities laws, U.S. investment banks generally will facilitate undocumented offerings under Rule 144A or Regulation S only after careful consideration of the circumstances, as the lack of a document heightens potential exposure under section 10(b) and Rule 10b-5, as well as potentially non-U.S. securities laws.<sup>43</sup> Among other things, the investment bank will consider the size of the issuer, its reporting history, the markets on which its shares trade and the liquidity of the trading, the quality of the issuer's reporting and research coverage, how much time has elapsed since the most recent periodic report and recent significant developments relating to the issuer, its industry and its home country.<sup>44</sup> In addition, placement may be limited to very sophisticated institutional investors and each investor will sign a letter acknowledging that it is not relying on the seller in making its investment decision and representing as to its sophistication and ability to bear the loss of the investment.<sup>45</sup>

These concerns generally are not present in the context of a block trade under Rule 144 where the sales are being done on behalf of a non-affiliate or in a manner that does not involve special selling efforts.

### 3.3.1. Rule 144

Rule 144 provides a non-exclusive safe harbor for the free resale in the United States of restricted securities and control securities by a selling securityholder.<sup>46</sup>

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<sup>43</sup> Undocumented offerings of this type, including by affiliates of the issuer, are more common in Europe and Asia than in the United States. Unlike in the United States, affiliate sales in these regions generally do not trigger registration requirements and can be done in a manner similar to ordinary course secondary market sales.

<sup>44</sup> If a selling securityholder is involved, the investment bank also will consider whether it is an affiliate of the issuer and how much access to material non-public information the seller has (*e.g.*, through a board representative), among other factors.

<sup>45</sup> The discussion in the text is focused mainly on offerings of common stock. It is of course possible to effect a block trade in other types of securities, such as convertible and straight debt. Debt securities trade predominantly among institutional investors, meaning that an exemption from registration may well be available, and there could be a substantially deep market in a particular bond to make a bought deal structure attractive.

<sup>46</sup> Rule 144 is not available to an issuer or its subsidiaries. *See* SEC Staff, Division of Corporation Finance, Compliance and Disclosure Interpretations: Securities Act Rules § 528.01, *available at* <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm> (last updated Feb. 27, 2012) [hereinafter Securities Act Rules CD&I] ("Rule 144 is not available for sales of an issuer's securities by its subsidiary, since a parent-issuer may not do indirectly through a subsidiary what it may not do directly under Rule 144. For example, a subsidiary, which is not a bank or trust company, that acts as trustee for its parent's employee benefit plan would not be permitted to rely on Rule 144 for sales of its parent's securities in connection therewith. [Jan. 26, 2009]" (citing Securities Act Release No. 33-5306 (Sept. 26, 1972))).

- “Restricted securities” generally are securities acquired directly or indirectly from an issuer, or from an affiliate of an issuer, “in a transaction or chain of transactions not involving any public offering.”
- “Control securities” are securities held by an affiliate of an issuer, whether restricted securities or securities acquired in the open market or in a registered offering.
- An “affiliate” of an issuer “is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with,” the issuer.<sup>47</sup>

A holder of restricted securities or control securities cannot publicly offer or sell the securities in the United States unless the offer or sale is registered under the Securities Act or an exemption from registration is available. Relying on Rule 144 avoids having to use a resale registration statement but, like a registered resale, results in a purchaser receiving unrestricted securities.

Rule 144 has five basic conditions, with the holding period condition being the most fundamental, because in certain circumstances, *restricted* securities held for a sufficiently long period may be sold without having to adhere to any of the rule’s other requirements. Sales of *control* securities, however, always must comply with the other four requirements of Rule 144 set forth below.

Restricted securities that are not control securities may be freely resold—*i.e.*, without complying with the other conditions of Rule 144 specified below for control securities—after they have been held<sup>48</sup> for at least six months after being acquired from the issuer or an affiliate of the issuer if (i) the issuer is, and has been for a period of at least 90 days immediately preceding the sale, an Exchange Act reporter, and satisfies the requirements set forth below under “Current Public Information” for Exchange Act-reporting companies (or, if the issuer is not current in its Exchange Act reporting or is not an Exchange Act-reporting company, the securities must be held for at least one year), and

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<sup>47</sup> Securities Act Rule 144(a)(1), (3). The SEC does not provide specific guidance on the definition of “control” for purposes of this definition of “affiliate.” However, Rule 405 under the Securities Act defines “control” as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.” The SEC views the *power* to exercise control, and not the *actual* exercise of control, to be the central consideration in determining whether control exists. Because of the lack of concrete indications of control articulated by the SEC, resolving the question is highly fact-intensive. Indicia of control may include ownership of more than 10% of an issuer’s outstanding voting securities or other factors, such as executive officer status, board representation or special voting rights (*e.g.*, a veto over significant corporate actions).

<sup>48</sup> For purposes of determining the length of the holding period, a holder may be permitted to include, or “tack,” periods during which prior non-affiliate holders held the restricted security, so that the aggregate holding period meets the requirements of Rule 144. If the issuer or an affiliate acquires and privately resells the securities, however, a new holding period will begin.

(ii) the seller is not (and has not been) an affiliate of the issuer within the three months preceding the sale date.

Sales of control securities, whether or not also restricted securities, must comply with the other four conditions of Rule 144 set forth below.

- *Amount of Securities Sold.* The amount of securities sold during any three-month period must not exceed the greater of (i) 1% of the outstanding securities of the class being sold, and (ii) if the class of securities is listed on a national securities exchange, the average weekly reported volume of trading in the issuer's securities on all national securities exchanges (and otherwise reported to the consolidated tape) during the four weeks prior to the filing of notice on Form 144 described below (or, if no such notice is required, the date of receipt by the broker of an order to execute the sale of securities or the date of execution directly with a market maker of the sale). For securities traded over-the-counter, only the 1% measurement may be used.<sup>49</sup>
- *Manner of Sale.* The securities (other than debt securities, non-participatory preferred stock and asset-backed securities) must be sold through a broker, in direct transactions with a market maker or in riskless principal transactions. In addition, among other limitations, soliciting or arranging for the solicitation of orders to buy the securities in anticipation of or in connection with the sale generally is prohibited. The sale must be handled as routine trading transaction, and if sold through a broker, the broker may not receive more than a normal commission.<sup>50</sup>
- *Current Public Information.* The issuer must satisfy certain public information requirements. The issuer must (i) be, and have been for a period of at least 90 days immediately before the sale, an Exchange Act-reporting company and (ii) have filed all required Exchange Act reports<sup>51</sup> during the 12 months preceding the sale (or for such shorter period that the issuer was required to file such reports). Even if the

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<sup>49</sup> An alternative volume test is available in the case of debt securities, non-participatory preferred stock and asset-backed securities. Specifically, in addition to the 1% and average weekly trading volume tests, an affiliate holder can sell, during the three-month period, up to 10% of the tranche or class being sold. *See* Securities Act Rule 144(e)(2).

<sup>50</sup> Although solicitation generally is prohibited, once a market maker has purchased the securities, it may solicit purchases.

<sup>51</sup> For purposes of this requirement, reports on Form 8-K (*i.e.*, periodic reports filed by U.S. issuers to report certain specified events) are disregarded, as are reports on Form 6-K (the analogous report for foreign private issuers). Accordingly, only the filing of Forms 10-K and 10-Q for domestic issuers and Form 20-F for foreign private issuers is relevant for purposes of determining if this requirement has been satisfied.

issuer is not an Exchange Act-reporting company, this requirement still may be satisfied if certain equivalent information is made publicly available.<sup>52</sup>

- *Notice of Proposed Sale.* Rule 144 requires the seller to file a Form 144 with the SEC (with a copy to the principal securities exchange on which the securities trade if they are listed) in the event the total amount of securities to be sold under Rule 144 during any three-month period exceeds 5,000 shares or has an aggregate sale price greater than \$50,000. The form must be filed concurrently with the placing of an order to execute the sale of the securities with the broker or with the execution directly with a market maker of such a sale.

### 3.3.2. Rule 144A

Rule 144A provides a non-exclusive safe harbor from registration for resales to institutions reasonably believed by the seller to be “qualified institutional buyers,” or “QIBs,” of securities that are not “of the same class,” or fungible, with securities listed on a national securities exchange (*e.g.*, NYSE or NASDAQ).<sup>53</sup> To be eligible as a qualified institutional buyer, an institution generally must be one of the types of institutions enumerated in the rule and own and invest on a discretionary basis at least \$100 million of securities of issuers that are not affiliated with the institution.<sup>54</sup> Of course, there must be a sufficiently deep market among QIBs to support the contemplated block trade.<sup>55</sup> (Absent such a market, a resale still may be structured using Rule 144A, but likely not on a bought-deal basis.)

Due to the fungibility requirement, Rule 144A generally does not work for exchange-listed securities. There is, however, an important exception to the fungibility requirement for securities of a class that are issued prior to the listing of that class—often referred to as “founders’ shares.” This exception would allow a selling securityholder to use Rule 144A to sell shares of common stock that it acquired prior to

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<sup>52</sup> Rule 144(c)(2) requires that certain information about a non-reporting issuer specified in Rule 15c2-11 under the Exchange Act be publicly available. *See* Exchange Act Rule 15c2-11(a)(5)(i)-(xiv), (xvi).

<sup>53</sup> Pink Sheets and OTC Bulletin Board bid and ask quotations for a security do not render Rule 144A unavailable.

<sup>54</sup> The enumerated institutions include, among others, corporations; partnerships; certain insurance companies; U.S.-registered investment companies, advisers and broker-dealers; certain employee benefit plans and trust funds; certain banks; and any entity all of the equity owners of which are QIBs. (For broker-dealers, the \$100 million threshold for securities owned and invested on a discretionary basis is reduced to \$10 million.)

<sup>55</sup> Historically, there has not been a significant secondary market for common stock trading under Rule 144A. Recently, however, there have been cases of significant pre-IPO trading (*e.g.*, in Facebook, Inc. common stock), facilitated in large measure by newly established trading platforms through companies such as SharesPost and SecondMarket. Trading on these platforms has been structured using Rule 144, traditional private resales (*see infra* note 56) and Rule 144A.

the issuer carrying out a U.S. listing of that stock.<sup>56</sup> Of course, it again would be necessary for there to be a sufficiently deep and liquid private market to support the trade.

Rule 144A imposes only two procedural requirements: (i) the seller must take reasonable steps to ensure that purchasers are aware that the seller may be relying on the rule; and (ii) in the case of issuers (other than foreign governmental issuers) that do not report or furnish information to the SEC under the Exchange Act, purchasers must have a right to obtain certain information concerning the issuer prior to sale.<sup>57</sup> As discussed in more detail in Chapter 2, purchasers in 144A transactions receive restricted securities that can be resold only upon registration or pursuant to an exemption from registration.

### 3.3.3. Regulation S

Regulation S is a complex exemption from registration covering offers and sales of securities outside the United States. The regulation contains two safe harbors. The first covers offers and sales by issuers and their affiliates, as well as distribution participants (*e.g.*, underwriters).<sup>58</sup> The second covers resales by others (*e.g.*, non-affiliate holders of restricted securities).<sup>59</sup> Regulation S generally is a cumbersome avenue for resale of

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<sup>56</sup> If Rule 144A is unavailable (*e.g.*, because the founders' stock exception is unavailable), the securities still may be resold on a private basis to a QIB or to an accredited investor ("AI") (a term that generally includes most institutions and certain wealthy individuals). *See infra* note 68. Because traditional resales fall outside the safe harbor provided by Rule 144A, to ensure that the securities are not resold to a person other than a QIB or AI, it generally is necessary to require (i) an opinion from counsel that the resale is exempt from registration, (ii) an investor representation letter from the purchaser addressing its status as a QIB or AI and certain other points relating to its purchase of the securities and (iii) certificated legended securities (which cannot be admitted to a clearing system). The investor representation letter also generally requires any subsequent sales by the purchaser to satisfy the same opinion and investment representation letter requirements. These requirements are essentially incompatible with the sort of market that would support block trades.

<sup>57</sup> This information includes a brief description of the issuer's business and the products and services it offers, as well as certain balance sheet, profit and loss and retained earnings statements, and similar financial statements for that portion of the two preceding fiscal years during which the issuer has been in operation.

<sup>58</sup> The first safe harbor applies to issuers and their affiliates, as well as underwriters and others that participate in the distribution of the securities pursuant to a contractual arrangement. Two conditions must be satisfied for an offer or sale to qualify: (i) the offer and sale must be an "offshore transaction" (as defined in Regulation S) and (ii) there may be no "directed selling efforts" (as defined in Regulation S). Securities Act Rule 903(a). In addition to the offshore transaction requirement and prohibition on directed selling efforts, further requirements may have to be met to qualify for the first safe harbor. The applicable requirements depend on the extent to which there is a nexus with the United States, with more stringent requirements applying the greater the SEC views a need for protection of U.S. investors. The spectrum ranges from Category 1, where the likelihood of the securities flowing back into the United States is most minimal, to Category 3, where that likelihood is greatest. *See* Securities Act Rule 903(b).

<sup>59</sup> The second safe harbor covers offshore resales by persons other than the issuer or an affiliate of the issuer, or a distributor or any of its affiliates, of securities initially placed offshore or by private placement in the United States. These persons generally can resell their securities outside the United States immediately, provided the "offshore transaction" requirement is satisfied and directed selling efforts are not used in the United States. *See* Securities Act Rule 904.

*equity securities of a U.S. issuer and accordingly is seldom used.*<sup>60</sup> For equity securities of a foreign private issuer, however, Regulation S can provide a useful path to liquidity.<sup>61</sup>

Although offerings under Regulation S may not be used to access the U.S. investor base, which can limit the potential market for the securities, a Regulation S offering can be carried out alongside a registered offering or an offering done pursuant to another exemption from registration.<sup>62</sup>

### 3.4. Other Considerations

#### 3.4.1. Sections 13 and 16 of the Exchange Act

In contemplating a block trade, selling securityholders should be mindful of any reporting obligations they might have under sections 13 and 16 of the Exchange Act, as well as the potential for short-swing profit liability under section 16. In general, a person must file a Schedule 13D or Schedule 13G if the person “beneficially owns” more than 5% of a class of Exchange Act-registered voting equity, along with amendments to update those filings in connection with material changes in beneficial ownership, among other things. Section 16 requires “insiders” of a domestic issuer<sup>63</sup> with Exchange Act-registered equity both to report their transactions in the issuer’s equity securities and, absent an applicable exemption, to disgorge to the issuer profits (or deemed profits) resulting from “short-swing” trading in the issuer’s equity securities—

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Notwithstanding the availability of this safe harbor, in practice, most resales of securities are covered by another exemption from registration, such as section 4(a)(1) of the Securities Act, which provides an exemption for transactions by any person other than an issuer, underwriter or dealer. The safe harbor of Rule 904 therefore generally is used only when the securities being offered or sold are restricted and the seller is not an affiliate of the issuer (or is an affiliate only by virtue of being a director or officer of the issuer, who are permitted to use this safe harbor, subject to certain limitations).

<sup>60</sup> In particular, equity securities offered by a U.S. issuer under Regulation S are treated as “restricted securities” and subject to cumbersome transfer mechanics. *See* Securities Act Rules 903 and 905.

<sup>61</sup> Of course, when offering securities offshore, it also is necessary to consider securities law and other requirements that may apply in the relevant jurisdictions. It often is possible to structure offshore offerings in a manner that avoids having to prepare a prospectus or otherwise comply with a process analogous to SEC registration.

<sup>62</sup> See Preliminary Note 5 to Regulation S: “Attempted compliance with any rule in Regulation S does not act as an exclusive election; a person making an offer or sale of securities may also claim the availability of any other applicable exemption from the registration requirements of the Act.”

<sup>63</sup> Rule 3a12-3(b) under the Exchange Act exempts securities registered by a foreign private issuer from U.S. proxy rules under section 14 of the Exchange Act and short-swing profit reporting and disgorgement rules under section 16 of the Exchange Act.

*i.e.*, matchable purchases and sales of those securities within six months of each other.<sup>64</sup> “Insiders” include officers, directors and shareholders beneficially owning more than 10% of a class of registered voting equity.

### 3.4.2. FINRA

Given the speed of execution associated with a block trade, it is important to ensure that all regulatory hurdles have been cleared in advance. A trap for the unwary can arise under FINRA’s Corporate Financing Rule, Rule 5110, which imposes limits on broker-dealer compensation, prohibits unfair and unreasonable underwriting practices and, most importantly, imposes filing and approval requirements in certain circumstances before a transaction can be launched.

The rule exempts filings by issuers of investment-grade non-convertible debt, as well as issuers that satisfy the requirements for shelf offerings on SEC Forms S-3 or F-3 pursuant to the standards for those forms in place prior to October 21, 1992.<sup>65</sup> These standards are more onerous than those in place today—in particular, they require at least 36 months of reporting under the Exchange Act and a public float of at least \$150 million (or, for Form F-3 issuers, at least \$300 million), or at least \$100 million and annual trading volume of at least 3 million shares. Accordingly, even a WKSI issuer that can file an immediately effective shelf registration statement can fail to satisfy the standard if it is a relatively new issuer. FINRA has procedures in place, however, that allow for a shelf registration statement to be cleared within one day.<sup>66</sup>

### 3.4.3. Shareholder Approval

In the context of an offering of common stock, both NYSE and NASDAQ generally require shareholder approval for, among other things, any issuance of common stock that is greater than or equal to 20%—in terms of number or voting power—of the shares of

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<sup>64</sup> In general, the term “equity security” is defined very broadly for purposes of section 16. In addition to common stock, the term “equity security” includes derivative securities, such as options to acquire stock and debt convertible into stock, as well as other contracts, rights or arrangements the value of which is based on the value of an equity security, including equity swap contracts. A transaction in a non-derivative equity security can be matched with a transaction in an equity derivative security.

<sup>65</sup> See FINRA Rule 5110(b)(7).

<sup>66</sup> These filing exemptions are not available to the extent an offering involves certain conflicts of interest. However, FINRA’s one-day clearance procedure still can be used. A conflict can arise, among other times, when at least 5% of the offering proceeds, not including underwriting compensation, is intended to be directed to a FINRA member participating in the offering or certain of its related persons. In these circumstances, a qualified independent underwriter (or “QIU”) must be involved in the offering process, absent an exemption. Exemptions from the QIU requirement include circumstances where (i) the FINRA member principally responsible for managing the offering does not have a conflict of interest and can meet certain other requirements and (ii) the securities being offered have a “bona fide public market” (as defined in FINRA Rule 5121(f)(3)). One or both of these exemptions often will be satisfied in the SEC-registered block trade context.

common stock outstanding prior to the issuance. A public offering for cash, however, generally should be exempt from this requirement.<sup>67</sup>

#### 3.4.4. Other

As indicated above in Section 2.4.3, for securities listed on a U.S. national securities exchange, the application of blue sky laws should be preempted under section 18 of the Securities Act. For offerings under Rule 144A, an exemption from the blue sky laws of each state should apply to the extent the trades are done through a registered broker-dealer, which generally will be the case. Regulation S offerings are not subject to blue sky laws because they are carried out offshore.

Rules 101 and 102 under Regulation M except transactions in Rule 144A-eligible securities sold to persons reasonably believed to be QIBs or to persons not deemed to be “U.S. persons” for purposes of Regulation S during the course of a Rule 144A offering.

## 4. Private Investment in Public Equity (PIPE)

### 4.1. Overview

A private investment in public equity (“PIPE”) transaction is a private placement of securities by a public company to a single or a limited group of accredited investors that typically is followed by the registration of the resale of those securities with the SEC.<sup>68</sup>

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<sup>67</sup> NYSE Listed Company Manual section 312.03(c) requires shareholder approval prior to the issuance of common stock, or of securities convertible into or exercisable for common stock, “if the common stock has, or will have upon issuance, voting power equal to or in excess of 20 percent of the voting power outstanding before the issuance of such stock or of securities convertible into or exercisable for common stock,” or “the number of shares of common stock to be issued is, or will be upon issuance, equal to or in excess of 20 percent 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, however, if the issuance involves a public offering for cash, or a bona fide private financing, if the financing involves a sale of common stock, for cash, at a price at least as great as each of the book and market value of the issuer’s common stock (or securities convertible into or exercisable for common stock, for cash, if the conversion or exercise price is at least as great as each of the book and market value of the issuer’s common stock).

NASDAQ Stock Market Rule 5635(d) requires shareholder approval prior to the issuance of securities in connection with a transaction other than a public offering involving the issuance “of common stock (or securities convertible into or exercisable for common stock) at a price less than the greater of book or market value which,” together with sales by officers, directors or substantial shareholders, equals 20% or more of the common stock—by number or by voting power—outstanding before the issuance.

The shareholder approval requirements of NYSE and NASDAQ also generally do not apply to a foreign private issuer. See NYSE Listed Company Manual, *supra* note 36, § 103.00; NASDAQ Stock Market Rules, *supra* note 36, IM-5615-3 (Foreign Private Issuers).

<sup>68</sup> An “accredited investor,” or “AI,” is defined in Rule 501(a) under Regulation D, which sets forth safe harbors under section 4(a)(2) of the Securities Act from SEC registration for private placements. See Chapter 2 for additional information regarding section 4(a)(2) and Regulation D.

A PIPE transaction can minimize execution risk and offer relatively quick financing for the issuer, while providing discounted pricing and favorable terms to the investor. The PIPE structure can be used to offer all types of securities, including common stock, convertible and non-convertible preferred stock, convertible debt, warrants and structured products.

PIPEs historically have been utilized by distressed or small- and mid-sized issuers when other financing options are not feasible. However, PIPEs also can be attractive to larger, well-capitalized issuers during periods of volatility and uncertainty in the markets as a relatively quick and discreet means to raise capital while minimizing market and execution risk.

#### 4.2. Key Considerations

An issuer might prefer a PIPE over a traditional offering for several reasons. Most importantly, a PIPE avoids potential delay from SEC review. Another significant advantage is that public disclosure of the transaction can be timed to occur only after investors commit to purchase the securities, thereby minimizing downward pressure on the issuer's stock price, as well as potential reputational damage if an offering is not completed.<sup>69</sup> Because a PIPE normally is done on a best efforts, rather than firm commitment, basis, it generally entails lower transaction expenses than a traditional underwritten registered offering.

Against these advantages, a number of considerations must be taken into account. PIPE investors receive restricted securities following the closing of the private placement. To compensate for the resulting lack of liquidity, investors typically insist on a potentially sizeable discount to the then-prevailing market price of the securities. In addition, because the securities usually are offered only to a limited set of investors, the terms of the offering may be extensively negotiated. In particular, investors may extract rights that typically are not associated with a traditional capital markets transaction, particularly if the issuer is distressed—*e.g.*, preemptive rights, negative covenants and board seats.

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PIPE transactions are typically limited to AIs for two main reasons. First, although securities may be sold under Rule 506(b) of Regulation D to up to 35 non-AIs, the rule allows for sales to an unlimited number of AIs. Second, Rule 502(b) of Regulation D requires extensive information to be furnished to any investors that are not AIs.

<sup>69</sup> In general, if the transaction is opportunistic and does not proceed, then no disclosure will be needed because the failure of the transaction to proceed will not be material. In circumstances where the transaction's failure is material—*e.g.*, because the issuer desperately needs capital and the failed PIPE shows that it is not likely to be able to obtain it—then disclosure may be warranted. Of course, as discussed above in Section 3.2.5 and in greater detail in Section 4.5.1 below, if material non-public information regarding the issuer, other than the fact of the transaction itself, is shared with potential investors, then that information should be disclosed or otherwise cease to be material (*e.g.*, due to the passage of time) before the potential investors should be permitted to trade in securities of the issuer.

### 4.3. Structure

In connection with the private placement, the issuer typically prepares a private placement memorandum that describes the terms of the offered securities and the issuer, usually by incorporating the issuer's publicly filed Exchange Act reports. An investment bank often is hired as placement agent to facilitate structuring and placement of the securities, though, strictly speaking, the securities will be sold directly by the issuer to the investor. Although the private placement is not subject to sections 11 and 12(a)(2) of the Securities Act, section 10(b) of, and Rule 10b-5 under, the Exchange Act do apply.<sup>70</sup> Accordingly, to help provide a defense against a potential liability, the placement agent may well insist on delivery of legal opinions and 10b-5 letters, as well as auditor comfort letters.

The issuer also generally will meet and conduct conference calls with investors, as well as provide investors the opportunity to perform due diligence, which is typically conducted by the lead investor and its counsel. Depending on the circumstances, the structure and the terms of the offering may be heavily negotiated with the lead investor and its counsel and be set out in a subscription or purchase agreement. In some cases, filing of the resale registration statement, and the SEC having indicated that it is prepared to declare the registration statement effective, is a condition to closing. In other cases, a registration rights agreement will be entered that obligates the issuer to file a resale shelf registration statement within a period of time after closing and use its best efforts to have it become effective, or otherwise to make specified payments to investors. Consistent with practice under section 4(a)(2) and Regulation D, settlement normally involves delivery of legended, physical certificates representing the securities.<sup>71</sup>

### 4.4. Resale Registration Statement

The SEC staff has indicated that a company will be permitted to register the resale of securities in a PIPE if the investor is at risk at the time the resale registration statement is filed, and is irrevocably bound to purchase a fixed number of securities for a fixed price that is not based on a market price or a fluctuating ratio, either at the time the registration statement goes effective or at any subsequent date.<sup>72</sup> In addition, "[t]here can be no

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<sup>70</sup> See *supra* note 41 and accompanying text.

<sup>71</sup> If the offering involves convertible securities or warrants eligible for Rule 144A exemption—*i.e.*, because they are sold only to QIBs and have an effective conversion premium greater than 10% and therefore are not "fungible" with listed securities for purposes of Rule 144A—settlement may occur through DTC using global securities. See *supra* text accompanying note 53.

<sup>72</sup> SEC Staff, Division of Corporation Finance, Compliance and Disclosure Interpretations: Securities Act Forms, Question 116.19, available at <http://www.sec.gov/divisions/corpfin/guidance/safinterp.htm> (last updated Aug. 11, 2010). When the registration statement relates to the resale of shares of common stock underlying unissued, convertible securities, the "analysis applies to the convertible security, not to the underlying common stock." *Id.*

conditions to closing that are within” the investors’ control or that the investors “can cause not to be satisfied”—*e.g.*, market price-related conditions or satisfactory completion of due diligence.<sup>73</sup>

If the PIPE does not meet these requirements, then the registration statement may not be viewed by the SEC staff as a valid secondary offering. Instead, it could be viewed as an indirect offering by the issuer, with the result that the investors would have to be identified as “underwriters” in the registration statement (an unappealing prospect given associated liability concerns),<sup>74</sup> and the issuer would have to be eligible to register the securities for sale on a primary basis.<sup>75</sup>

## 4.5. Communications with Potential Investors

### 4.5.1. Material Non-Public Information

To facilitate the due diligence process, prevent potential investors from trading on the basis of material non-public information and avoid violations by the issuer of Regulation

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<sup>73</sup> *Id.*

<sup>74</sup> Section 2(a)(11) of the Securities Act defines “underwriter.” It is a transaction-based concept that historically has led to difficult interpretive questions: “The term ‘underwriter’ means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors’ or sellers’ commission. As used in this paragraph the term ‘issuer’ shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.”

By contrast, the definition of “dealer” in section 2(a)(12) turns on the basis of the person’s typical business: “‘dealer’ means any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person.” Status as a dealer, however, can affect whether a party will be deemed an underwriter.

See also the Preliminary Note to Rule 144, which further discusses the interpretive difficulties raised by section 2(a)(11) and how Rule 144 provides a safe harbor from being deemed an underwriter.

<sup>75</sup> See *supra* note 7 and accompanying text for a discussion of eligibility to use Forms S-3 and F-3 on a primary basis.

It is possible to use Form S-1 for resale registration, but the process can be cumbersome due to inability to incorporate Exchange Act filings by reference and the need to make post-effective amendments to reflect certain fundamental updates. The SEC Staff has stated: “Question: When Form S-1 is used for a continuous offering under Rule 415, is a post-effective amendment necessary to meet the requirements of Section 10(a)(3), to reflect fundamental changes, or to disclose material changes in the plan of distribution? Answer: Yes. A post-effective amendment is required to reflect those changes because Form S-1 does not provide for forward incorporation by reference of Exchange Act reports filed after the effective date. Other changes may be made by prospectus supplement to the extent permitted by Rule 424. [Jan. 26, 2009].” Securities Act Rules CD&I, *supra* note 46, Question 212.11.

FD, potential investors in a PIPE will be required to enter into a confidentiality agreement. The term of the agreement runs until the launch of the transaction or until a specified date when all material information shared with potential investors will have been disclosed or no longer be material (*e.g.*, due to the passage of time). As discussed above in connection with block trades, the fact that an issuer is contemplating a PIPE itself is likely material non-public information.<sup>76</sup>

#### 4.5.2. JOBS Act

The Jumpstart Our Business Startups Act of 2012 (“JOBS Act”), which requires the revision of Rule 506 under Regulation D to permit general solicitation and general advertising to be used in certain Rule 506 offerings, is unlikely to have a significant impact on PIPE transactions.<sup>77</sup> An issuer often undertakes a PIPE to obtain financing on a discreet basis by securing definitive commitments from investors before any public announcement of the transaction. Although general solicitation and general advertising will not further this aim, it is conceivable that an issuer that is temporarily unable to carry out a registered offering (or does not wish to do so due to timing constraints) will use this newfound flexibility to raise capital from a broader investor base than in a traditional PIPE offering.<sup>78</sup>

#### 4.6. Shareholder Approval—Stock Exchanges

Shareholder approval may be necessary prior to conducting an offering through a PIPE transaction. The most common reason for seeking shareholder approval is to comply with the rules of the relevant securities exchange. As noted above, both NYSE and NASDAQ generally require shareholder approval for, among other things, any issuance of common stock that is greater than or equal to 20%—in terms of number or voting power—of the shares of common stock outstanding prior to the issuance.<sup>79</sup> They also require shareholder approval if an issuance will result in a change of control of the issuer.<sup>80</sup> In addition, shareholder approval may be required at much lower thresholds

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<sup>76</sup> See *supra* Section 3.2.5.

<sup>77</sup> The SEC has proposed rules to implement this provision of the JOBS Act. See *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Securities Act Release No. 33-9354 (Aug. 29, 2012).

<sup>78</sup> For years, issuers have been offering straight debt securities under Rule 144A and Regulation S and then carrying out so-called “A/B exchange offers” or “Exxon Capital” exchange offers whereby they commit to exchange within a specified time the initially placed restricted securities with securities that have identical terms and have been registered with the SEC on Form S-4 or Form F-4 and therefore are unrestricted.

<sup>79</sup> See *supra* note 67 and accompanying text.

<sup>80</sup> See NYSE Listed Company Manual, *supra* note 36, § 312.03(d); NASDAQ Stock Market Rules, *supra* note 36, Rule 5635(b).

when shares are issued to a director, officer or substantial holder—which may be more likely in the PIPE context where existing investors may provide substantial support to distressed issuers.<sup>81</sup> Both NYSE and NASDAQ have a financial viability exception from the shareholder approval requirements, though the invocation of the exception sometimes is avoided for fear that the invocation itself may cause or deepen the issuer’s financial problems.<sup>82</sup>

#### **4.7. Large Holder Considerations**

##### *4.7.1. Sections 13 and 16*

Investors acquiring more than 5% or 10% of a class of Exchange Act-registered voting equity, or acquiring a board seat in an Exchange Act-reporting issuer, should be mindful of their reporting and potential short-swing profit disgorgement obligations under sections 13 and 16, respectively.<sup>83</sup> Such investors are also subject to limitations on short sales under section 16(c) of the Exchange Act.

##### *4.7.2. HSR Act*

The Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (“HSR Act”), imposes pre-merger notification and waiting period obligations on transactions over a certain size (“Size of Transaction”). The Size of Transaction test is met if the acquiring person will acquire and hold certain assets, voting securities or interests in non-corporate entities valued at more than \$283.6 million. Alternatively, if the Size of Transaction exceeds \$70.9 million, the HSR Act thresholds are met if the parties are greater than a certain size (“Size of Parties Test”).

The Size of Parties Test generally will be triggered if one party to the transaction has at least \$14.2 million in total assets or annual net sales, and the other has at least \$141.8

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<sup>81</sup> NYSE Listed Company Manual section 312.03(b) imposes a shareholder approval requirement in connection with the issuance of common stock (or securities convertible into common stock) to, among others, a director, officer or substantial securityholder of the company “if the number of shares of common stock to be issued, or if the number of shares of common stock into which the securities may be convertible or exercisable, exceeds” 1%—by number or voting power—of the shares of common stock outstanding before the issuance. If the substantial securityholder is not otherwise related to the issuer, and if the issuance relates to a sale of stock for cash at a price at least as great as each of the book and market value of the issuer’s common stock, then the 1% threshold is instead 5%.

<sup>82</sup> NYSE Listed Company Manual section 312.05 provides for a financial distress exception upon application to the exchange where “the delay in securing stockholder approval would seriously jeopardize the financial viability” of the issuer and the audit committee of the issuer has approved expressly reliance by the issuer on the exception. An issuer relying on the exception must mail notice of its use to all shareholders at least 10 days before the relevant issuance. NASDAQ Stock Market Rules, *supra* note 36, Rule 5635(f) contains a substantially similar exception.

<sup>83</sup> *See supra* Section 3.4.1.

million in total assets or annual net sales. An acquisition made “solely for investment purposes”—a phrase defined quite narrowly—is exempt from the HSR Act if the acquisition results in the investor owning no more than 10% of the outstanding voting securities of the issuer.

#### 4.7.3. *Banking Regulation*

U.S. bank regulatory issues invariably arise for investments in U.S. bank holding companies and foreign banks with U.S. banking operations. Similar issues can also arise for investments in diversified financial services firms and even some commercial companies, if they have a depository institution or trust company in the group. These transactions tend to be structured as small, passive, non-controlling investments because a controlling investment in a banking organization subjects the investor to regulatory supervision and significant limits on the investor’s activities and investments. A non-controlling investment is typically structured to be less than 25% (or sometimes 10%) of the banking organization’s voting securities and total equity. An investor also must take care to structure its relationship with the banking organization to avoid exercising a “controlling influence,” which can arise from a wide range of investment positions, board participation rights, funding and credit exposures, business relationships and contractual rights. An investor with a significant minority interest in a banking organization is sometimes required to make contractual “passivity commitments” to U.S. bank regulators to avoid a finding of control.

Alternatives for structuring a passive, non-controlling investment in a banking organization will vary depending on the particular facts and circumstances of the investment, including the investment’s size and form (*e.g.*, voting securities, non-voting equity, debt), whether the investor is itself subject to U.S. regulation as a bank holding company or similar regulated entity, and any other business relationships between the investor and the investee. Structuring investments in this space, in particular, requires careful attention to banking laws, regulations and formal and informal interpretations.

#### 4.7.4. *CFIUS*

In general, the Committee on Foreign Investment in the United States (“CFIUS”) has the authority to review transactions in which a foreign person acquires direct or indirect “control” over a U.S. company to determine whether national security issues may exist.

“Control” is a very flexible concept that might be better thought of as “substantial influence under all the circumstances.” CFIUS has reviewed transactions that would not be thought of as conferring control in the ordinary sense, and in any event it has authority to review a transaction to determine whether control exists. “National security” is equally flexible and extends well beyond traditional military issues to include protection of critical infrastructure, such as utilities and networks, potential terrorism targets such as chemical plants, and access to high technology. As a practical

matter, these tests may be applied differently on a case-by-case basis, with the level of scrutiny depending in part on the identity of the acquiror and the sensitivity of the U.S. assets.

CFIUS filing is not mandatory, but CFIUS has authority to review transactions that are not notified even after closing and has been increasingly aggressive in doing so. CFIUS has authority to impose conditions on the acquiror to mitigate any threat to national security or, if it concludes mitigation is not possible, to recommend that the U.S. President prohibit the transaction or order divestiture.

There are several presumptive exclusions from CFIUS review, including: (i) acquisition of voting securities representing less than 10% of outstanding voting securities, solely for passive investment purposes; and (ii) acquisition of convertible voting securities (though the conversion itself is reviewable) if conversion is speculative, considering factors such as whether conversion is imminent, whether conversion depends on events outside the control of the acquiror, and whether the interest to be acquired upon conversion can be determined. However, these are presumptions that may be overcome in light of particular facts and circumstances, rather than absolute rules, and the presumptions will not apply if the investor participates in governance (for example, through a board seat or consent rights that go beyond a narrow set of investor protection rights).

#### *4.7.5. DGCL Section 203*

Section 203 of the Delaware General Corporation Law (“DGCL”) generally prohibits an “interested stockholder”—generally a person beneficially owning 15% or more of a corporation’s voting stock or an affiliate or associate of that person—from engaging in a “business combination” for three years following the date on which the person became an interested stockholder. The prohibition generally does not apply if the board of directors of the issuer approves the transaction in which the stockholder becomes an interested stockholder or the business combination before the stockholder becomes an interested stockholder. Without this prior board approval, the business combination must be approved by the board and stockholders with at least two-thirds of the outstanding voting stock of the issuer not owned by the interested stockholder.

#### *4.7.6. Net Operating Loss Carryforwards*

In general, section 382 of the Internal Revenue Code of 1986, as amended, limits a U.S. corporate taxpayer’s utilization of a net operating loss following an “ownership change.” An ownership change generally occurs when the percentage of common stock owned by one or more holders of at least 5% of the common stock increases by more than 50 percentage points from the lowest percentage of common stock that was owned by

the 5% stockholders in the preceding three-year period.<sup>84</sup> A particularly large placement to an already significant holder may result in an ownership change for these purposes.

#### 4.8. Hedging-Related Considerations

Certain investors in PIPE transactions, such as hedge funds, may seek to hedge their investment—*e.g.*, by short selling the shares to be acquired in the PIPE (or the shares underlying a convertible instrument to be acquired in the PIPE).

The SEC has brought several enforcement actions against investors for short sales of common stock when the sales occurred prior to the time that the resale registration statement became effective, and were then covered with securities purchased in the PIPE once the registration statement became effective.<sup>85</sup> The premise of these actions is that section 5 of the Securities Act—which generally requires every offer and sale of securities to be registered with the SEC or exempt from registration—is violated by the short sale because it is an offer and sale of securities that have not yet been registered. Although the SEC’s view did not prevail in these cases,<sup>86</sup> it continues to adhere to it.<sup>87</sup>

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<sup>84</sup> If the limitation applies, the corporate taxpayer can only offset taxable income in taxable years following the ownership change with pre-change net operating losses by an amount generally equal to the product of (i) the applicable federal long-term exempt rate in effect on the date of the ownership change and (ii) the value of the taxpayer’s equity immediately prior to the change (or the annual limitation). Any unused annual limitation may be carried forward to increase the amount of income that may be offset by the net operating loss in subsequent years. *See* I.R.C. § 382.

<sup>85</sup> The SEC also has brought insider trading actions against certain investors who sold the equity securities short after learning of the upcoming PIPE but prior to its public announcement. *See, e.g.*, SEC Files Enforcement Action Against Hedge Fund Manager Jeffrey Thorp and Three Hedge Funds for Engaging in Illegal “PIPE” Trading Scheme (*SEC v. Langley Partners*), SEC Litigation Release No. 19607 (Mar. 14, 2006); Federal Court Finds Hedge Fund Manager Liable for Securities Fraud in Connection with PIPE Investments (*SEC v. Berlacher*), SEC Litigation Release No. 21648 (Sept. 14, 2010); *S.E.C. v. Cuban*, 620 F.3d 551 (5th Cir. 2010). The confidentiality agreement entered into by each investor with the issuer should prohibit explicitly trading on the basis of material non-public information. Even if it does not, the SEC staff has made clear its view that trading on the information while subject to a duty of confidentiality is sufficient to form the basis for an insider trading action: “Question: If an issuer gets an agreement to maintain material nonpublic information in confidence, must it also get the additional statement that the recipient agrees not to trade on the information in order to rely on the exclusion in Rule 100(b)(2)(ii) of Regulation FD? Answer: No. An express agreement to maintain the information in confidence is sufficient. If a recipient of material nonpublic information subject to such a confidentiality agreement trades or advises others to trade, he or she could face insider trading liability. [Aug. 14, 2009]” SEC Staff, Division of Corporation Finance, Compliance and Disclosure Interpretations: Regulation FD, Question 101.05, *available at* <http://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm> (last updated June 4, 2010).

<sup>86</sup> *See SEC v. Lyon*, 529 F. Supp. 2d 444, 459 (S.D.N.Y. 2008); *SEC v. Mangan*, 598 F. Supp. 2d 731, 733 n.5 (W.D.N.C. 2008); *see also SEC v. Berlacher*, Fed. Sec. L. Rep. (CCH) P96,738 (E.D. Pa. 2012) (ruling that the SEC’s position was substantially justified for purposes of attorney fee shifting despite the court’s rejection of the argument at the pleadings stage because the SEC’s section 5 liability theory “has not been tested above the district court level, has been strongly defended by at least one legal scholar, and has been used successfully by the SEC as a settlement tool”).

Accordingly, market participants have continued to structure their hedging activity in a manner consistent with the SEC’s position by (i) generally waiting some period of time before hedging to avoid statutory underwriter concerns and (ii) engaging in “double print” transactions. Double printing refers to purchasing shares in the market to close out a short position (*i.e.*, delivering those shares to the purchaser in the short sale or the stock lender that provided shares initially used to settle the short sale). The restricted securities acquired in the PIPE are sold in the market roughly contemporaneously, but with sufficient time between the trades so that they are separate and the investor is subject to some market risk.<sup>88</sup>

#### 4.9. Registered “PIPEs”—Registered Direct Offerings

“Registered direct” offerings, sometimes oxymoronically referred to as “registered PIPEs,” have characteristics similar to PIPE transactions, except that the securities offered already have been registered under an effective shelf registration statement, thereby avoiding the need to go through the two-step process of a private placement followed by a registered resale. Like a PIPE, a registered direct generally is marketed on a best efforts basis to a select group of investors. In contrast to a PIPE, however, the securities may be offered and sold to non-AI investors because the offering is public and the securities will not be restricted securities, meaning that there should not be as much of a liquidity discount.

Registered directs commonly are done using contingency structures—*e.g.*, “all or none” (*i.e.*, no securities will be sold unless all offered securities are sold) or “min-max” (*i.e.*, offered securities will be sold if a minimum is met, but subject to a cap on the overall amount sold). Using these structures can involve some additional administrative burden because Exchange Act rules require escrowing of the proceeds until the contingency is satisfied.<sup>89</sup>

Targeted marketing also may result in a narrower distribution of securities than in a customary, fully marketed deal. Moreover, if the offering is for 20% or more of the

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<sup>87</sup> See SEC Staff, Division of Corporation Finance, Compliance and Disclosure Interpretations: Securities Act Sections, Question 239.10, *available at* <http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm> (last updated Mar. 4, 2011) (“An issuer filed a Form S-3 registration statement for a secondary offering of common stock which is not yet effective. One of the selling shareholders wanted to do a short sale of common stock ‘against the box’ and cover the short sale with registered shares after the effective date. The issuer was advised that the short sale could not be made before the registration statement becomes effective, because the shares underlying the short sale are deemed to be sold at the time such sale is made. There would, therefore, be a violation of Section 5 if the shares were effectively sold prior to the effective date. [Nov. 26, 2008]”).

<sup>88</sup> The SEC has accepted this approach as consistent with its views. See, *e.g.*, *In re Spinner Asset Management, LLC*, Securities Act Release No. 33-8763 (Dec. 20, 2006); Complaint at 2, *SEC v. Berlacher*, No. 07-3800 (E.D. Pa. Sept. 13, 2007).

<sup>89</sup> See Exchange Act Rules 15c2-4, 10b-9.

outstanding common stock of the issuer at a discount to the market price, the stock exchanges may not treat it as sufficiently “public” as to benefit from the public offering for cash exemptions from their shareholder approval requirements.<sup>90</sup> In addition, a FINRA filing also will be needed if the 1992 requirements for use of Form S-3 or F-3 are not satisfied.<sup>91</sup>

To manage its liability risk, the placement agent will insist on due diligence comparable to a traditional underwritten registered offering and standard documentation will be required, including legal opinions, 10b-5 letters, comfort letters and other supporting documents.

## 5. Rights Offerings

### 5.1. Overview

In a rights offering, an issuer’s existing shareholders receive the opportunity to purchase, on a pro rata basis, newly issued shares of the issuer’s common stock at an exercise price typically set at a significant discount to the market price of the common stock. Although rights offerings historically have been common in Europe due to statutory preemptive right requirements, they generally have been relatively uncommon in the United States.<sup>92</sup> Rights offerings in the United States historically have been viewed as a less favorable method of raising capital and traditionally have been associated with smaller or distressed companies.

A rights offering, however, can be a useful means for an issuer of any size or financial condition to raise capital. In contrast to a large PIPE, for example, a rights offering may be a useful way of raising a substantial amount of capital while avoiding shareholder approval requirements (because it is a public offering for cash), having to make significant corporate governance concessions (because there is no individual negotiation) and avoiding change of control triggers (because the likelihood of a change is low, as contrasted with a concentrated issuance to a small set of investors). A rights offering also may be appealing to the issuer during periods of market turmoil, when the issuer’s valuation is significantly depressed, because existing shareholders may well have a stronger and more enduring view of the issuer’s value and thus offer a cheaper source of financing than a traditional offering targeting new investors. As an investor relations matter, existing holders also may appreciate the opportunity to maintain their pro rata

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<sup>90</sup> See *supra* Section 3.4.3.

<sup>91</sup> See *supra* Section 3.4.2.

<sup>92</sup> European statutory preemptive rights can in certain circumstances be sidestepped with appropriate board or other approval or pursuant to another available exception, thereby facilitating a more traditional follow-on equity offering by the issuer.

position in the issuer at a discount (or the ability to sell transferable rights and realize value if they do not wish to further invest).

In recent years, rights offerings also have been used increasingly in the bankruptcy context to facilitate the issuer's exit from proceedings under Chapter 11 of the U.S. Bankruptcy Code. A rights offering can allow the issuer to raise cash to pay off creditors, be structured to permit creditors to exchange their debt for equity or be a means through which existing equity holders can inject cash and retain their equity position in the reorganized issuer.<sup>93</sup>

## 5.2. Structure

Rights are issued, at no cost, to existing shareholders as of a specified record date.<sup>94</sup> The rights entitle the shareholders to purchase additional shares, based on a set subscription ratio of a number of new shares for each right, at a given exercise price during a fixed subscription period. Assuming full exercise by a shareholder of its rights, the shareholder will not be diluted as a result of the rights offering. A number of key structural points, such as the exercise price, subscription ratio, transferability of the rights and the involvement of an underwriting or backstop commitment for unsubscribed shares can affect the attractiveness of the offering and the likelihood of its success.

The issuer usually will engage third parties to assist in the offering process. A broker-dealer is typically engaged to serve as the dealer-manager. The dealer-manager helps develop the marketing strategy for the rights offering and solicit the exercise of rights, and may act as a market maker in the rights if they are transferable. A subscription agent, which is typically the issuer's transfer agent, disseminates the rights along with the related offering documents, such as a prospectus or prospectus supplement, collects subscription forms and related payments from exercising shareholders and calculates participation. Questions and requests for further information regarding the logistics of the rights offering are usually handled by an information agent.

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<sup>93</sup> The U.S. Bankruptcy Code contains a special exemption from Securities Act registration for the issuance of securities by an issuer in Chapter 11. In general, section 1145 exempts from registration the issuance of securities pursuant to a bankruptcy plan where the securities are issued principally in exchange for existing claims or equity.

<sup>94</sup> On NYSE, an "ex-rights" date typically precedes the record date by two trading days, so that a purchaser that buys shares of the issuer on or after the ex-rights date would not be a record holder as of the record date and therefore would not be entitled to the rights when distributed. In some cases, the exchange may require that the ex-date not occur until all necessary approvals have been obtained for the offering to proceed (*e.g.*, shareholder approval or effectiveness of the SEC registration statement for the offering) and accordingly defer the ex-rights date until after the "record date." If that happens, then the shares will trade with so-called "due bills," which means that sellers effectively will assign their rights to the purchasers thereof until the date set by the exchange. See NYSE Listed Company Manual, *supra* note 36, § 703.03. See NASDAQ Stock Market Rules, *supra* note 36, Rule 11140(a) for the NASDAQ approach to setting the ex-rights date. See also Exchange Act Rule 10b-17.

### 5.2.1. *Exercise Price and Subscription Period*

The issuer generally seeks to set the exercise price at a sufficiently discounted level to attract investors to subscribe for the additional shares, while not setting it so low as to risk adverse market perception or the accomplishment of its financing goals. Determination of an optimal exercise price requires a balancing of a number of other considerations, too, including the concentration of the issuer's shareholder base and the likelihood of shareholder participation, the amount of dilution to non-exercising shareholders, recent market conditions and the volatility of the stock price. The dealer-manager typically assists the issuer with fixing the price, subscription ratio and other terms for the offering. The subscription period usually lasts in the range of 16 to 30 days after the rights have been granted. A rights offering also may include an "over-subscription" privilege that allows a shareholder that exercises its rights in full to subscribe for additional shares if there are any unexercised rights.

### 5.2.2. *Transferability*

Rights may or may not be transferable by the shareholders. Transferability generally promotes greater exercise of the rights by allowing interested investors to purchase the rights and invest in the issuer's stock at a discounted price.<sup>95</sup> If the rights are transferable, the issuer usually lists them for trading during the subscription period on the same securities exchange on which the underlying common stock is listed.<sup>96</sup> If the rights are not transferable, a holder that does not exercise its rights will be diluted without any compensation.<sup>97</sup>

### 5.2.3. *Underwriting or Backstop Commitments*

In a non-underwritten and non-backstopped rights offering, the risk that shareholders will not subscribe in full for the shares is borne by the issuer. Where it is crucial that the rights offering will successfully raise a targeted level of capital, the issuer may arrange an underwriting or backstop commitment to purchase any shares not subscribed for during the subscription period (sometimes referred to as the "rump" shares).

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<sup>95</sup> Some investors use a so-called "tail swallow" structure whereby they sell just enough rights to cover the exercise price for their remaining rights.

<sup>96</sup> See NYSE Listed Company Manual, *supra* note 36, § 703.03(N).

<sup>97</sup> *Id.* Section 703.03(N) touches on this point: "The Exchange considers it highly desirable, from the standpoint of public interest, that dealings in subscription rights, and in the security being offered, be conducted in the same market as the beneficiary security, where all three will be subject to the same market conditions and will be affected thereby in proper relative proportions. There is the further consideration that the subscription right represents a realizable part of the market value of the beneficiary security, and where the latter is listed on the Exchange, it is appropriate that shareholders desirous of selling their subscription rights be afforded the facilities and benefits of the Exchange auction market for that purpose."

One or more broker-dealers, usually led by the dealer-manager of the offering, would be engaged in the context of an underwriting. Alternatively, investors, such as one or more existing major shareholders of the issuer, often will agree to provide a backstop (also known as a standby commitment). In contrast to a traditional underwriter, which is looking to earn a fee from placing the shares and not to be left with a stake in the issuer, backstop providers often are interested in acquiring a stake or augmenting their existing position.<sup>98</sup> Underwriters will be paid a fee, and backstop providers almost always also will receive a fee for their commitment.<sup>99</sup> Backstop providers sometimes also will commit to purchase additional shares in a private placement alongside the rights offering at the subscription price. In addition, backstop providers often obtain registration rights to facilitate their ability to resell any shares they acquire.<sup>100</sup>

### 5.3. Legal and Regulatory Considerations

#### 5.3.1. Shareholder Approval and Large Holder Considerations

One of the key considerations in structuring a rights offering is whether shareholder approval will need to be obtained prior to conducting the offering.<sup>101</sup> In the context of a rights offering, it is especially advisable to discuss any shareholder approval-related concerns well in advance with the relevant securities exchange because the exchanges do

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<sup>98</sup> In some cases, both traditional underwriters and backstop providers may provide commitments.

<sup>99</sup> In some cases, the backstop provider will forgo a fee because it is a major shareholder and focused principally on restoring the issuer to financial viability or views the opportunity to purchase additional shares at a discount pursuant to the backstop as sufficient.

<sup>100</sup> Traditional underwriters should be able to sell rump shares pursuant to the rights offering registration statement, and the possibility of their doing so should be described in the plan of distribution. For backstop providers, the backstop is tantamount to a private placement of securities to them, resulting in their acquiring restricted securities at closing and thereby needing a resale registration statement (or an exemption from registration) to be able to sell freely. Because backstop providers, as selling shareholders, bear some risk of being treated as statutory underwriters—see *supra* note 74—they may well negotiate for typical underwriter protections in the registration rights agreement (*e.g.*, due diligence rights, as well as the right to receive opinions, 10b-5 letters and comfort letters).

Traditional underwriters also sometimes implement a so-called “Shields Plan” to help manage their underwriting risk. A Shields Plan involves purchases by the broker-dealers of rights during the rights trading period, combined with sales of a corresponding amount of shares underlying the rights. Such a plan should be permissible under Regulation M, which replaced certain rules that more heavily regulated rights offerings: “In light of the treatment of derivative securities under Regulation M, the Commission is rescinding Rule 10b-8, which pertained to distributions through rights. This rule contained overly rigid and complex restrictions on purchases of rights and regulated sales of offered securities. Bids for and purchases of rights are not subject to Rules 101 and 102, although bids for and purchases of a security that is the subject of a rights distribution are restricted by these rules.” Anti-manipulation Rules Concerning Securities Offerings, Securities Act Release No. 33-7375; Exchange Act Release No. 34-38067; Investment Company Act Release No. IC-22412 (Dec. 20, 1996) (adopting Regulation M).

<sup>101</sup> See *supra* Sections 3.4.3, 4.6.

not have written rules specifically addressing shareholder approval in the context of rights offerings.<sup>102</sup> A rights offering of 20% or more of the outstanding common stock, and with no underwriting or backstop commitment, should not require shareholder approval insofar as it is a public offering for cash. The introduction of underwriting or backstop arrangements, however, could alter this conclusion in some circumstances (*e.g.*, where the underwriter or backstop providers earn a fee or where a backstop provider is a substantial securityholder).

As with any offering of securities, but particularly in the context of a rights offering given the large number of shares that often is issued, it is important to confirm that the issuer has sufficient authorized share capital.

A rights offering also can implicate many of the same issues as were discussed above in the context of a PIPE to the extent it can result in a significant number of shares being issued to a single holder, particularly an underwriter or backstop provider. Accordingly, it is necessary to consider whether the rights offering could result in a change of control or trip a relevant regulatory threshold, and investors will need to analyze potential section 13 and section 16 obligations.<sup>103</sup> In particular, underwriters and backstop providers, especially existing stockholders that come together to support the rights offering, will have to consider the extent to which they may have formed a “group” for purposes of sections 13 and 16 and accordingly need to treat themselves as the beneficial owners of each other’s securities.<sup>104</sup>

### 5.3.2. SEC Registration

Although the grant of rights in itself is for no consideration, the purchase of shares pursuant to the exercise of rights is an offer of those shares and accordingly must be

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<sup>102</sup> NYSE Listed Company Manual, *supra* note 36, section 703.03(A) in fact urges issuers to contact NYSE well in advance of a rights offering: “Because of the complexity encountered in rights offerings and the necessity for arranging a time schedule which will coordinate the various actions to be taken, it is recommended that the company confer with their Exchange representative well in advance of the offering date.”

<sup>103</sup> Traditional underwriters should be able to look to Rules 13d-3(d)(4) and 16a-7 under the Exchange Act for some measure of protection in this regard. The former provides that a person engaged in business as an underwriter that acquires the securities through participation in good faith in a firm commitment SEC-registered underwriting will not be deemed the beneficial owner of the securities until 40 days after the date of the acquisition. The latter similarly exempts from section 16 reporting purchases and sales made in connection with a distribution of a substantial block of securities in good faith in the ordinary course of business.

<sup>104</sup> In general, a group is formed “[w]hen two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer.” Exchange Act Rule 13d-5(b)(1).

registered.<sup>105</sup> As noted above, a backstop provider also often will obtain registration rights to facilitate its ability to resell any shares it acquires.<sup>106</sup>

A rights offering by a foreign private issuer may be exempt from the registration requirements of the Securities Act pursuant to Rule 801 under the Securities Act. This exemption is available if 10% or less of the class of stock in respect of which rights are being issued is held of record by U.S. holders and applies only to all-cash rights offerings made on a pro rata basis to all shareholders of the class (including American Depositary Receipts (“ADRs”) evidencing the shares). The exemption provided by Rule 801 is available to issuers only, and underwriters will not be able to rely on the exemption for resales of any rump shares. Accordingly, any such shares sold in the United States would have to be privately placed with QIBs or AIs. In addition, rights issued to U.S. shareholders under Rule 801 are not transferable except outside the United States in accordance with Regulation S, though the shares underlying the rights are freely transferable in the United States so long as the shares in respect of which the rights are issued are unrestricted securities. In addition, the issuer must consent to service of process in the United States. A rights offering under Rule 801 is not subject to liability under sections 11 and 12(a)(2) of the Securities Act, but is subject to section 10(b) of, and Rule 10b-5 under, the Exchange Act.<sup>107</sup>

In circumstances where Rule 801 is not available or not feasible to use, and SEC registration is impractical or undesirable, a foreign private issuer may choose, subject to any applicable constraints under non-U.S. laws, to exclude U.S. holders from participating in a rights offering, or extend the rights offering to U.S. holders only on a private placement basis. In these circumstances, the issuer generally would arrange for the rights to be sold for the benefit of U.S. holders (other than any U.S. holders participating by way of private placement) and remit the cash to them.

### 5.3.3. *Securities Exchanges*

Both NYSE and NASDAQ impose a number of rules relating to the conduct of a rights offering, including those governing notices and setting of the record date.<sup>108</sup> These rules are in addition to any shareholder approvals that must be obtained in connection with a rights offering. NYSE has more extensive rules, procedures and guidance relating to

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<sup>105</sup> As with any public offering involving FINRA members (*i.e.*, essentially any U.S. broker-dealer), it may be necessary to make a filing under FINRA Rule 5110 unless an exemption is available. *See supra* Section 3.4.2.

<sup>106</sup> A traditional underwriter should be able to sell rump shares pursuant to the rights offering registration statement, and the possibility of its doing so should be described in the plan of distribution. *See supra* note 100.

<sup>107</sup> *See supra* notes 41-42 and accompanying text.

<sup>108</sup> *See, e.g.*, NYSE Listed Company Manual, *supra* note 36, § 703.03 (governing rights offering for NYSE-listed securities); NASDAQ Stock Market Rules, *supra* note 36, Rule 11140.

rights offerings, though NASDAQ generally applies similar principles. For example, NYSE generally requires a minimum of 10 calendar days' advance notice of the record date and subscription price and a subscription period that runs at least 16 days,<sup>109</sup> while NASDAQ does not have specific requirements on these points. As noted above, however, it is important to coordinate with the exchanges well in advance of a rights offering, as each rights offering tends to introduce its own particular structuring considerations, and the exchanges generally will be accommodating if given sufficient notice. Rights offering mechanics can be particularly challenging to structure in the context of shares that trade on multiple exchanges—*e.g.*, where a foreign private issuer is listed both in its home country and through ADRs in the United States—because the rules and procedures in each jurisdiction almost invariably conflict at least to some degree. With sufficient advance coordination, however, these conflicts usually can be resolved to the satisfaction of all parties involved.

## 6. Structures Involving Public Investment Vehicles

ATM programs, block trades, PIPE transactions and rights offerings all provide alternative techniques for existing issuers to raise additional capital. By contrast, a private equity-style sponsor or management team specializing in a particular type of investment might want to create a publicly financed vehicle to acquire a business or invest in certain assets. SPACs and BDCs are designed for these purposes. From the perspective of the private companies or smaller public companies that may be the subject of an acquisition or an investment by a SPAC or a BDC, these structures provide a source of necessary capital that otherwise may be unavailable. From the perspective of investors in these vehicles, they are given the opportunity to participate in investments to which they otherwise may not have had access.

### 6.1. Special Purpose Acquisition Company (SPAC)

#### 6.1.1. Overview and Structure

A SPAC is a special purpose company formed to acquire one or more operating companies or businesses and initially is a public shell or “blank check” company with no assets or operations.<sup>110</sup> The SPAC conducts an SEC-registered initial public offering

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<sup>109</sup> The subscription period can be shortened to 14 days in certain circumstances. *See* NYSE Listed Company Manual, *supra* note 36, § 703.03(E).

<sup>110</sup> Rule 405 under the Securities Act defines a shell company generally as a company that has “no or nominal operations,” and either “no or nominal assets,” “assets consisting solely of cash and cash equivalents” or “assets consisting of any amount of cash and cash equivalents and nominal other assets.”

Rule 419(a)(2) under the Securities Act defines a blank check company generally as “a development stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person,” and “is issuing ‘penny stock,’ as defined in Rule 3a51-1 under” the Exchange Act.

(“IPO”) to raise capital from institutional and retail investors. Typically, the SPAC sells units comprising a share of common stock and a warrant to purchase a share of common stock (which generally is not exercisable until the closing of the acquisition made by the SPAC) and lists these securities on a securities exchange.<sup>111</sup> The sponsors usually retain approximately 20% of the equity in the SPAC.<sup>112</sup>

Substantially all the proceeds from the IPO are deposited into a separate, typically interest-bearing, escrow account, referred to as a “trust account,” administered by a trustee. The funds in the account are used principally to finance an acquisition that the SPAC will pursue post-IPO, though the SPAC must not have any particular acquisition target in mind at the time of the registration of the IPO. The SPAC seeks to locate and close an acquisition within a specified period, usually 18 to 36 months following the IPO. The acquisition usually must have a value equal to at least 80% of the SPAC’s net assets or the value of the trust account. The small portion of funds that are not put in escrow are used to fund the SPAC’s pre-acquisition operating expenses (*e.g.*, due diligence relating to potential acquisition targets, and legal and accounting expenses relating to the acquisition of a target).

Some SPACs are formed with a focus on a particular industry or geography, though others have a broader range of possible targets. Once a potential acquisition has been identified and an acquisition agreement is entered into with the target, shareholder approval by at least a majority of the SPAC’s publicly held common stock must be obtained to complete the acquisition.<sup>113</sup> Shareholders that vote against the acquisition have the option to redeem their common stock (though the warrants are usually retained) for a pro rata portion of the amount held in the trust account. Many SPACs therefore also feature a redemption threshold condition, which provides that an acquisition may not be completed if holders of a fixed number of the outstanding shares of common stock (generally 20-40%) redeem their common stock. If an acquisition target is not

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Rule 419 imposes a number of constraints on an offering by a blank check company, including a requirement that all securities issued by the company be deposited in escrow and not trade until an acquisition is completed. Similarly, the bulk of the offering proceeds also must be escrowed. Rule 419 requires that the acquisition represent at least 80% of the offering proceeds, and imposes an 18-month limit on how long the issuer has to complete the acquisition. A SPAC is exempt from Rule 419, however, to the extent it has net tangible assets of at least \$5 million following its IPO (because it then will not be considered a penny stock issuer). Nonetheless, as indicated in the text, the usual SPAC structure normally incorporates some features of Rule 419.

<sup>111</sup> A listing, as contrasted with mere over-the-counter trading, provides an exemption from blue sky laws. *See supra* Section 2.4.3.

<sup>112</sup> In many cases, the sponsors also are subject to lock-up arrangements, pursuant to which they agree to not to sell their interests until a specified time after the completion of the acquisition.

<sup>113</sup> The specific level of shareholder approval differs across SPACs, but charter documents often require shareholder approval by a majority or supermajority, whether or not required by the law of the SPAC’s jurisdiction.

identified within the specified period, the SPAC is liquidated and the shareholders receive their pro rata portion of the trust account.

The size of a SPAC can vary significantly from tens of millions to hundreds of millions of dollars. Regardless of size, the SPAC structure may offer several benefits for both the sponsor seeking financing and public investors. For the sponsor, raising a significant amount of cash through a SPAC can be an easier and cheaper source of funding than raising capital on a private basis. Private financing may not be sufficient or be available only on undesirable terms. For the investors, a SPAC can provide an opportunity to participate in an investment with potentially substantial returns to which they otherwise might not have had access. The level of control granted to investors through shareholder approval requirements and cash redemption rights also may be appealing. In addition, the listing of the SPAC's securities on a securities exchange provides the investors with liquidity.

### *6.1.2. Legal and Regulatory Considerations*

The IPO of a SPAC is registered with the SEC using a registration statement on Form S-1 or Form F-1 and is conducted in substantially the same manner as an IPO of an operating company.<sup>114</sup> In contrast to an IPO of an operating company, however, the registration statement and the prospectus focus on the structure of the SPAC and its business strategy, including its management team's background, qualifications and experience and any industry or geography focus of possible targets. A statement must also be made in the registration statement that no acquisition targets have been identified at the time of the IPO. Because the SPAC will not have any operations or substantial assets prior to the IPO and the acquisition, financial information and related disclosures generally are relatively minimal.<sup>115</sup>

As a publicly listed company, a SPAC will be subject to Exchange Act reporting requirements and securities exchange rules. In particular, a SPAC will be subject to the proxy rules under the federal securities laws that govern communication with shareholders and solicitation of proxies for shareholder votes. Accordingly, a SPAC is required to disclose all necessary information relating to a shareholder vote on a proxy statement and file it with the SEC in accordance with Regulation 14A under the

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<sup>114</sup> As an ineligible issuer under Rule 164 under the Securities Act, a SPAC will not be permitted to use free writing prospectuses or electronic road shows, which may limit marketing flexibility. (See also Forms S-3 and F-3, and Rule 144, which impose constraints on the ability of a shell company to rely on them.)

<sup>115</sup> Although an ineligible issuer for purposes of Rule 164, a SPAC that completes its IPO after December 8, 2011 may be able to qualify as an "emerging growth company," or "EGC," under Title I of the JOBS Act. An EGC can take advantage of a more flexible IPO process and relaxation of certain reporting and corporate governance-related requirements—*e.g.*, relief from the requirement for an independent audit of management's internal control assessment, new public company accounting standards and executive compensation-related disclosures and requirements.

Exchange Act. Because the filed proxy statement is subject to review by the SEC, a delay of shareholder vote caused by a lengthy review process could adversely impact the SPAC's ability to timely consummate an acquisition.

### 6.1.3. *Challenges and Recent Structures*

The traditional SPAC structure described above in some cases has presented governance-related obstacles that affected the ability to timely and efficiently consummate an acquisition. For example, some SPACs attracted arbitrageurs that sought to exploit structural features of the SPAC to lock in low-risk profits. Under one strategy, the investor would purchase units in the IPO, sell the warrants soon thereafter, oppose all acquisitions and then redeem the common stock for the corresponding pro rata portion of the cash trust account. In addition to the warrant price, the investor would receive their cash investment back, with interest. A SPAC in this or a similar situation would find itself seeking new investors to vote in favor of a proposed acquisition or having to make arrangements to encourage the blocking investor to sell out.<sup>116</sup>

Some SPACs have sought to increase the certainty of completing an acquisition, and to avoid the risk of a lengthy proxy review process, by replacing the mandatory shareholder approval requirement and redemption threshold condition with an issuer tender offer. Under this approach, the SPAC makes a tender offer for its outstanding shares and provides information about the acquisition in the offer to purchase. The SPAC does not complete the acquisition if more than a specified percentage of shares are tendered.<sup>117</sup> This structure allows the SPAC to complete the acquisition even if a substantial majority of stockholders elects to participate in the tender offer, while affording investors that otherwise would oppose an acquisition an opportunity to receive their cash investment back. Moreover, the tender offer rules under the Exchange Act restrict purchases of shares outside the tender offer and require that all participants in the tender be paid the same price. As a result, the SPAC is precluded from making separate arrangements with opposing investors that might otherwise seek to extract concessions from the SPAC.

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<sup>116</sup> In some cases, SPACs obtained the consent of certain investors only after entering into forward purchase contracts with those investors.

<sup>117</sup> Some structures provide for other standards to determine whether the issuer tender offer (and the closing of the acquisition) should be completed, such as a minimum amount of net tangible assets that must remain in the SPAC.

In other cases, a SPAC may set that threshold at such a high level that the acquisition is highly likely to go forward. To the extent that the tender offer depletes the cash resources of the SPAC, it may well use borrowing to facilitate its ability to pay the purchase price for the target.

## 6.2. Business Development Company

### 6.2.1. Overview

A BDC is a type of closed-end investment company under the Investment Company Act of 1940, as amended (the “Investment Company Act”), designed to facilitate capital raising by small- and mid-sized private U.S. companies through the establishment of a public vehicle that invests in these private companies.<sup>118</sup> Like a SPAC, a BDC is a public company that has raised capital by offering its common stock to the public through an SEC-registered IPO. An election to become a BDC also must be filed with the SEC.<sup>119</sup>

A BDC may be internally or externally managed. An internally managed BDC has employees to supervise and conduct daily operations, relying on cash, profit-sharing or equity-based arrangements to incentivize management. An externally managed BDC is like a mutual fund insofar as it is operated by a third-party investment adviser registered with the SEC and does not employ its own personnel.

The recent trend generally has been in favor of an externally managed model, with an investment adviser compensated based on a fee structure. The structure typically comprises a base management fee of approximately 1.5% to 2.5% of the gross assets of the BDC’s portfolio and a two-part performance fee consisting of 20% on the BDC’s realized capital gains and 20% of the BDC’s pre-performance fee net investment income.<sup>120</sup> The payment of the performance fee typically is tiered and is subject to a “hurdle rate” and a “catch-up rate” that are each set as a certain percentage of all net investment income earned by the BDC.

A BDC indirectly provides its investees with access to the public markets. At the same time, a BDC provides public investors with a means to invest in publicly traded securities in an entity making private equity-style investments.<sup>121</sup> The structure also

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<sup>118</sup> A “business development company” is defined in section 2(a)(48) of the Investment Company Act.

<sup>119</sup> See Form N-6 and Form N-54A.

<sup>120</sup> Section 205(b)(3) of the Investment Advisers Act of 1940, as amended (the “Investment Advisers Act”), generally permits an investment adviser of an externally managed BDC to receive performance-based compensation so long as it does not exceed 20% (exclusive of any base management fee) of realized capital gains over a specified period or as of definite dates, net of realized capital losses and unrealized capital depreciation. Subject to certain other exceptions set forth in section 205(b) of the Investment Advisers Act, an incentive fee based on capital gains would not be permitted for an investment adviser for a non-BDC investment company.

<sup>121</sup> Investors in a BDC also benefit from certain additional protections. For example, a majority of a BDC’s board of directors must not be “interested persons,” and a BDC is prohibited from engaging in certain types of transactions with affiliates. See Investment Company Act §§ 56, 57. The transactions with affiliate restrictions are, however, less onerous than those that apply to non-BDC investment companies under section 17 of the Investment Company Act.

provides the BDC with capital that is not subject to shareholder redemption (in contrast, *e.g.*, to a mutual fund or a SPAC), and a BDC has greater flexibility to incur debt than a traditional SEC-registered closed-end investment company.<sup>122</sup>

Under the Investment Company Act, a BDC generally must invest at least 70% of its assets in securities of “eligible portfolio companies”<sup>123</sup> and a limited number of other types of investments, including cash, government securities and short-term debt instruments.<sup>124</sup> Among other requirements, a BDC’s investment portfolio also must be diversified to limit concentration of any one position to no more than 25% of total holdings and the BDC must make a minimum distribution of 90% of the BDC’s taxable earnings every year.<sup>125</sup> Accordingly, unlike a SPAC, a BDC generally does not acquire an entire business or even controlling stakes in companies. In fact, many publicly traded BDCs invest primarily in debt rather than equity.

### 6.2.2. *Securities Law Considerations*

The regulatory framework relating to offerings of securities by a BDC differs somewhat from that of other issuers, including SPACs. A BDC conducting an IPO must register its securities on a registration statement on Form N-2, which requires information similar to that required by Form S-1,<sup>126</sup> including disclosure regarding the terms of the offering, contemplated use of proceeds, investment objectives, risk factors and management team. Like a SPAC, however, the prospectus will contain minimal financial information and related disclosure.<sup>127</sup> As an Exchange Act registrant, a BDC also will be subject to ongoing reporting obligations, as well as the proxy rules (and listing requirements to the

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<sup>122</sup> A BDC is subject to a lower required asset coverage ratio in respect of its debt (200%) than a traditional closed-end investment company (300%). *See* Investment Company Act §§ 18(a)(1)(A), 61(a)(1).

<sup>123</sup> “Eligible portfolio companies” are defined in section 2(a)(46) of the Investment Company Act and generally include private U.S. companies and smaller U.S. public companies that are not listed on a national securities exchange.

<sup>124</sup> *See* Investment Company Act § 55(a).

<sup>125</sup> The diversification requirement and the minimum distribution requirement are driven by tax-related considerations so that the BDC obtains pass-through tax treatment—*i.e.*, does not have to pay income taxes at the corporate level in respect of the income or gains the BDC distributes to its shareholders.

<sup>126</sup> Like a SPAC, a BDC can qualify as an EGC. *See supra* note 115.

<sup>127</sup> Like a SPAC, a BDC is not permitted to use a free writing prospectus or an electronic roadshow. *See* Securities Act Rule 164(f). Instead, it must use advertisement materials pursuant to Rule 482 under the Securities Act to communicate certain information to potential investors. In addition, “access equals delivery” under Securities Act Rule 172, which deems electronic availability of the prospectus to be equivalent to physical delivery in certain circumstances, is not available.

extent the BDC is listed on a securities exchange), and investors in the BDC may be subject to reporting and short-swing profit disgorgement under sections 13 and 16.<sup>128</sup>

## 7. Other Strategic Transaction Structures

### 7.1. Spin-offs

#### 7.1.1. Overview

A spin-off transaction involves a distribution by a parent company to its shareholders of all or a substantial portion of the shares in a subsidiary. A spin-off generally is done for strategic purposes, such as allowing management of the parent company to focus on its core business, being able to more directly incentivize employees at both companies, highlighting a high-growth business whose value otherwise is obscured, eliminating a conflict between the two companies or facilitating a business combination relating to one of the companies following the spin-off.<sup>129</sup> A properly structured spin-off can be accomplished as a tax-free transaction for both the issuer and its shareholders.<sup>130</sup>

#### 7.1.2. Process and Related Considerations

Implementing a spin-off transaction usually requires substantial planning and preparation as separation of a business from an existing organization generally is a complex process involving operational, financial, accounting, legal, employment, tax and other concerns. For example, it is necessary to ensure that no change of control or asset sale covenants are tripped in debt instruments or other financing arrangements of the subsidiary and the parent, and a shareholder vote could be required in some circumstances. It also is necessary to ensure that employees, assets and liabilities are properly allocated between the two entities and that any ongoing arrangements between the two companies are fully agreed and properly documented.

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<sup>128</sup> See *supra* Section 3.4.1.

<sup>129</sup> Instead of distributing a subsidiary to its shareholders, a parent also could choose to sell the subsidiary, in whole or in part, to the public in a “carve-out” IPO.

Although not currently in vogue, parent companies also sometimes synthetically replicate the effects of a spin-off through the creation of tracking stock in a business or a subsidiary. The tracking stock is a separate class of equity of the parent whose return is based on the performance of the relevant business or subsidiary. The tracking stock structure may lead to conflicts within the board of directors and among stockholders, because a single board owes duties to stockholders with divergent interests.

<sup>130</sup> See I.R.C. § 355. To qualify as a tax-free distribution under section 355 of the Internal Revenue Code, the spin-off transaction must satisfy a number of requirements, including those relating to a proper corporate business purpose, active conduct of the business for a requisite period of time, distribution of sufficient shares of the subsidiary to place the shareholders in control of the subsidiary, and continuity of interest between shareholders of the parent and the subsidiary.

A spin-off generally must be registered under the Securities Act unless: (i) “the parent’s shareholders do not provide any consideration for the subsidiary’s shares”; (ii) “the spin-off is pro rata to the parent’s shareholders”; (iii) “the parent has a valid business purpose for the spin-off”; (iv) “the parent provides adequate information about” the spin-off transaction and the subsidiary to its shareholders and to the market; and (v) if the parent spins off “restricted securities,” it has held those securities for a specified holding period (unless the subsidiary was formed by the parent).<sup>131</sup> If these conditions are not met, the spin-off transaction could be deemed to involve the offer and sale of securities to the parent’s shareholders and therefore require registration under the Securities Act.

Even if registration under the Securities Act is unnecessary, which is generally the case, satisfaction of the adequate information requirement generally requires a subsidiary that is not an Exchange Act-reporting company either to become one or to prepare an information statement describing the spin-off transaction and the subsidiary. The level of required disclosure is similar to that in an SEC registration statement, although the information statement would not be subject to SEC review. In any event, it may be most desirable from a business point of view to register such a subsidiary under the Exchange Act to facilitate listing on a securities exchange.

## **7.2. Reverse Mergers**

### *7.2.1. Overview*

In a “reverse merger,” a private operating company seeking to go public merges with an already public shell company instead of conducting an IPO. Because no traditional IPO is done, a registration statement is not required to be filed with, and reviewed by, the SEC at the time of the reverse merger. However, following the completion of a transaction that has the effect of causing a public shell company to cease being a shell company, such as in a reverse merger, comprehensive information regarding the transaction must be filed with the SEC on Form 8-K. The disclosure filed on Form 8-K includes a level of information that is substantially similar to what would be required in a registration statement, but the Form 8-K is not reviewed by the SEC.

### *7.2.2. Benefits and Risk*

A reverse merger permits a private company, including one located outside the United States, to become a public company in the United States relatively quickly by circumventing SEC registration and the traditional public securities offering process. This significantly reduces costs (because no underwriters are involved and the amount of documentation is minimized) and is much less burdensome on the management of the private company seeking to go public (because no registration statement is prepared and

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<sup>131</sup> SEC Staff Legal Bulletin No. 4 (Sept. 16, 1997).

no marketing efforts are required). Additionally, unlike an IPO, a reverse merger does not involve capital raising and therefore is not dilutive to the existing shareholders of the private company.

Despite these advantages, there are a number of potential downsides. One major disadvantage is that it may be difficult to develop market support and financial analyst coverage for the shares. Because the traditional IPO process is avoided, the company forgoes the opportunity to present itself to the public. Moreover, avoiding the traditional IPO process, through which multiple parties are involved in scrutinizing the finances and operations of the company, may mean greater opportunity for abuse. The shell company into which the private company merges may have had a history of undisclosed problems, and conversely, a private company with a host of problems may become a public company without public investors receiving the benefit of the vetting provided by a traditional IPO process.

Due to the prevalence of abuses involving reverse mergers, the SEC recently issued an investor bulletin outlining the risks of investing in a reverse merger company.<sup>132</sup> The SEC and securities exchanges have suspended trading in a number of reverse merger companies, citing a lack of current, accurate information about these companies and their financial condition. Securities exchanges also recently imposed tougher listing standards for reverse merger companies.<sup>133</sup> Against this backdrop, even absent abuse, legitimate private companies that seek to conduct a reverse merger may risk reputational damage.

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<sup>132</sup> See SEC Office of Investor Education and Advocacy, Investor Bulletin: Reverse Mergers (June 2011), available at <http://www.sec.gov/investor/alerts/reversemergers.pdf>.

<sup>133</sup> To be eligible to list on NYSE, for example, a reverse merger company would have to (i) trade for at least one year in the U.S. over-the-counter market or on another national securities exchange or a regulated foreign securities exchange, (ii) file all required reports with the SEC, including audited financial statements, and (iii) maintain a minimum share price of \$4 for an extended period. NYSE Listed Company Manual, *supra* note 36, § 102.01F.

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