

# INSIGHTS

THE CORPORATE & SECURITIES LAW ADVISOR

ASPEN PUBLISHERS

Volume 21 Number 5, May 2007

## SECURITIES REGISTRATION

### Unblocking Clogged PIPEs: SEC Focuses on Availability of Rule 415

*The SEC staff has provided guidance on when resale registrations of securities purchased in PIPE transactions and equity line financings will be treated as indirect primary offerings. The staff has confirmed that the concerns regarding PIPEs relate primarily to securities with variable conversion ratios and exercise prices rather than those involving common stock and fixed price convertible securities and warrants.*

by Stanley Keller and William Hicks

Since early 2006, the SEC has been raising issues regarding the availability of Rule 415 for resale shelf registrations of privately placed securities, typically so-called PIPE offerings. A PIPE (private investment, public equity) involves the private offering, usually of equity securities, followed by registration of the resale of the securities to give the investors liquidity. The SEC staff has cited an infrequently referred to telephone interpretation that indicates that an ostensible registered resale offering on Form S-3 (or a resale Form SB-2<sup>1</sup>) may, under certain circumstances, be considered an indirect primary offering for which the shelf registration form may not be available and other restrictions may apply.<sup>2</sup> Initially, the SEC staff applied this position to common stock PIPEs, but recently it has made clear that, although the telephone interpretation continues to apply, the concern relates primarily to PIPEs involving securities with variable conversion ratios and exercise prices rather than those involving common stock and fixed price convertible securities and warrants.<sup>3</sup>

During this period, the SEC also has raised issues in connection with equity line offerings.<sup>4</sup> In an equity line, the investor commits to purchase equity securities from a company and the company has the ability to call for the investment when it chooses, typically subject to certain conditions. When the investor is an affiliate, the SEC staff treats the equity line as a direct primary offering for which the issuer would have to meet the requirements for a primary shelf registration. In addition, the SEC staff has treated equity lines as primary offerings where the proceeds of the equity line were available to repay a bridge financing, particularly when the bridge financing was convertible or included warrants.

The SEC's positions have caused significant uncertainty in the PIPE and equity line financing markets, especially for companies that are not primary Form S-3 eligible because their public float is less than \$75 million. Even transactions that were completed before the SEC began to take these positions were held up in the registration process, and some issuers were not permitted to register as many shares as they had agreed to in PIPE purchase documents. Initially, there was an absence of guidance as to what would be necessary to clear these registrations with the SEC and what would work in the future. As a result, PIPE investors were faced with illiquidity for investments already made, companies were exposed to penalties, new financings, including follow-on tranches conditioned on an effective registration, were not being done and some traditional PIPE investors were deserting the field. The uncertainties caused by the SEC's positions were affecting the ability of smaller public companies to obtain financing or to obtain it on reasonable terms.

## SEC Guidance

While all the issues have not been resolved, earlier this year the SEC provided informal guidance regarding the availability of Rule 415 for PIPE transactions and, as noted, that guidance has recently been expanded to clarify which types of transactions are of most concern. The SEC also provided informal guidance regarding equity lines. The SEC's guidance has permitted pending resale registrations to become effective, and has allowed parties to structure transactions in a manner consistent with the SEC's positions. The guidance also has resulted in more consistent application of these positions across reviewing groups within the SEC.

One likely consequence of the PIPE guidance is to encourage a move away from securities with draconian variable conversion ratios and exercise prices. Another may be to limit the number of shares sold in PIPEs involving securities with variable conversion ratios or exercise prices to an amount that the SEC staff likely will allow to be registered immediately for resale. However, limiting the size of a PIPE offering can raise serious business issues for smaller issuers if it reduces the amount of capital raised below what is needed to execute their business plan.

## PIPE Transactions

As the PIPE market has evolved in recent years, the SEC has become concerned that the number of shares being registered in relation to the number of outstanding shares and the redistribution intentions of PIPE investors who are selling shareholders indicate that these registered resale offerings are really primary offerings being registered on forms that the company is not eligible to use and cannot be done as "at-the-market offerings." The SEC also has been concerned about the adequacy of disclosure to investors in the resale transaction.

While these concerns can apply to transactions involving all types of securities, including common stock and fixed price convertible securities and warrants, they are most pronounced when variable rate or market reset convertible securities or warrants are involved because of the potentially significant dilution and the large number of shares that were sought to be registered to cover that potential dilution. As a result, the SEC has raised issues on these potentially "toxic" variable rate securities offerings. At the same time, the SEC staff has indicated that its historic guidance regarding PIPE transactions has not changed.<sup>5</sup>

The consequences for PIPE investors and issuers if the investors' resale transaction is treated as a primary offering in disguise are often unacceptable and at odds with the fundamental nature of a PIPE investment. For an issuer that is not eligible to use Form S-3 for a primary offering, the unavailability of Rule 415 has the following consequences:

- The issuer must register the resale transaction on the form it is eligible to use for a primary offering (Form S-1 or SB-2), which involves the inconvenience of being unable to update through forward incorporation of reports filed under the Securities Exchange Act of 1934.
- The selling shareholders are deemed to be underwriters and must be identified as such in the resale registration statement. The "underwriter" designation and exposure to underwriter liability can be unacceptable to many PIPE investors.
- The issuer can only register the common stock underlying convertible securities at the time of each conversion, thus resulting in potentially unacceptable liquidity uncertainty for investors.
- The offering cannot be "at-the-market" under Rule 415 and the PIPE investors are therefore limited to reselling their shares on a registered basis at a fixed price identified in the registration statement. Further, the staff has indicated it will object if a company seeks to register the entire resale transaction as a "continuous" offering and then periodically files prospectus supplements or post-effective amendments to frequently change the "fixed" resale price. Requiring PIPE investors to resell their entire investment in a one-time fixed price offering is fundamentally inconsistent with their investment objective.

An issuer who is primary S-3 eligible would still be able to register the transaction on Form S-3 as an "at-the-market" primary offering under Rule 415, but it would have to name the selling shareholders as underwriters. Thus, the ability to use Rule 415 for the "primary" offering would be small consolation if the PIPE investors were unwilling to suffer the potentially enhanced liability exposure of being identified as underwriters. Accordingly, issuers and investors are focusing on how to structure PIPEs so that the resale transaction is not treated as a primary offering in the first place.

In determining whether a resale transaction is in reality an indirect primary offering, the SEC has indicated that it presumptively will view the registration of more than one-third of the pre-PIPE transaction public float (*i.e.*, the number of outstanding shares held by non-affiliates) as a primary offering, at least when the securities involved are convertible securities

or warrants with variable conversion ratios or exercise prices. Correspondingly, the registration of less than one-third of the public float is a guideline for what generally will be allowed as a resale registration on Form S-3 under Rule 415.

Even if more than one-third of the public float is sought to be registered, it is possible, based on the particular facts, to persuade the SEC that the transaction should nevertheless be treated as a resale secondary offering under Rule 415. The relevant factors might include:

- The nature of the securities being registered (convertible securities and warrants with variable conversion ratios and exercise prices are likely to raise concerns while the SEC staff has indicated that common shares and fixed rate convertible securities and fixed exercise price warrants are unlikely to).
- The amount of shares involved.
- The number of selling shareholders, whether they have “buy and hold” or “flipping” histories and the percentage of the offering purchased by each (a large number of buy and hold investors each taking relatively small portions of the deal is the most favorable scenario).
- The circumstances under which the selling shareholders received the shares and how long they have held them.
- The relationship of the selling shareholders with the company and each other and whether they are affiliates.
- Whether the selling shareholders are in the business of underwriting or buying and selling securities.
- The discount and other fees received by the selling shareholders, as well as the severity of penalties for missing registration related deadlines.
- Whether based on all the circumstances the selling shareholders are acting as a conduit for the issuer.

If selling shareholders who are deemed to be affiliates are involved, even if resale registration is otherwise permitted, the SEC staff, depending on the circumstances, might require the transaction with these persons to be registered as a primary offering, with the affiliates being named as underwriters.

When the amount of securities registered for resale is limited in accordance with the SEC guidance, the company will be able to register another tranche of the securities for a selling shareholder upon the later of: (1) 60 days after that selling shareholder and its affiliates have resold substantially all of their securities that were registered; or (2) six months after the effective date of the prior registration statement. The ben-

efit of this flexibility is limited for investors that desire to hold their shares until the Company hits important milestones and then be in a position to sell a significant portion of their shares at the anticipated increased value. Thus, the SEC’s position on registering additional tranches, while intended to provide flexibility, actually rewards steady flipping rather than long term investing.<sup>6</sup> This is because it limits the ability of a long term investor to achieve liquidity to sell its entire position when it chooses after six months have passed if it has not previously sold down its position. The SEC staff also has clarified that ordinarily Rule 144 will be available for resale by these investors following the rule’s holding periods.<sup>7</sup>

The SEC’s concerns about PIPE transactions are grounded in the adequacy of disclosure to investors in the resale offering; again, this concern is primarily directed towards offerings involving convertible securities and warrants with variable conversion ratios and exercise prices. These disclosure concerns apply both to companies that are primary S-3 eligible and those that are not. The staff will be looking for information on:

- The potential dilution and the impact of that dilution.
- The value of the securities being registered for resale and the relation to the proceeds received by the company (after possible payments to selling shareholders and their affiliates within one year).
- The payments and fees, including interest, to selling shareholders and their affiliates.
- The possible profit to them as a result of the initial purchase discounts and conversion discounts.
- Prior transactions between the company and the selling shareholders and their affiliates and other past or planned relationships and agreements.
- Plans regarding repayment of the convertible securities and the ability of the company to do so.
- How the number of securities sold and being registered were determined.
- Any actions or plans of the investors to hedge their positions, for example through short sales, and any immediate resale plans.

As noted, the SEC staff recently has sought to make clear that, although previously they have challenged issuers to explain why even common stock PIPEs were not primary offerings, their concerns relate principally to securities for which the conversion rate or exercise price adjusts with the company’s common stock market price and thus provides the greatest potential for dilution and raises the most significant disclosure concerns. Although the telephone interpre-

tation referred to above continues to apply to fixed securities, like common stock and fixed rate convertible securities, transactions involving these securities, if properly structured, are unlikely to raise the same SEC concerns under Rule 415.

## Equity Lines

The SEC has made clear that its prior interpretations permitting equity lines are to be narrowly construed and has provided the following additional guidance:

- The equity line must be completed when the registration statement is filed and there can be no renegotiation of material terms (such as extending the term of the line).
- The SEC staff position that permits an equity line to be registered as a resale registration so long as the issuer uses a form for which it is eligible for a primary offering is not available if the investor is an affiliate because the offering is then deemed to be a direct primary offering.
- Any caps imposed on the investor's ability to acquire shares will be ignored by the staff in assessing affiliate status because such caps are contractual in nature and can be waived or amended by the parties.
- The staff objects to the use of escrows for the committed funds.
- The investor cannot be in a position to delay the issuer's ability to call on the equity line, such as through a diligence provision or a certification requirement.
- The investor's obligation cannot be transferable or assignable.
- An issuer may only issue and register common stock under an equity line. Thus, the equity line may not be used to issue convertible securities or warrants as part of the equity line because the investor would then have a further investment decision.
- The price of the common stock under an equity line can float with the market but, in order for the commitment to be complete, any floor or ceiling to a price collar cannot be changed by the parties or waived.
- A bridge financing before registration of the equity line is permissible so long as the proceeds of the equity line are not used to repay the bridge debt.
- The investor can receive convertible securities or warrants in a reasonable amount before registration of the equity line, such as in connection with a bridge financing, but only if they are convertible or exercisable at a fixed price.
- There must be adequate disclosure of all fees, side deals and related transaction, as well as the proposed use of proceeds from the line (such as repayment of loans).
- The equity line cannot be used to effect an initial

public offering; rather, there must be an existing trading market.

- If the amount of securities being registered is substantial in relation to the issuer's public float, the offering will be considered in reality an issuer primary offering. Presumably, the same principles applicable to PIPEs will apply here.

## Changes in Practice

The SEC's recent guidance, although still potentially impeding some transactions that might otherwise take place, provides a roadmap that enables companies and investors to structure their transactions with knowledge of the applicable ground rules and with an ability to price them in light of the known liquidity constraints. Appropriate contractual arrangements are still being developed but some patterns have emerged.

The focus of the contractual arrangements has been on changes to the registration covenant and related liquidated damages provisions for failure to meet registration targets included in the PIPE purchase documents. The practice for these provisions is evolving, and they typically address the following issues:

- *Securities initially registered.* Agreements may require initial registration of: (1) all investor shares, while recognizing the possibility that the amount may be cut back as a result of SEC comment; or (2) the maximum number of the investor shares permitted by SEC guidance, defined as a specified amount (such as one-third of the public float) or the maximum allowed by the SEC. There are even examples of agreements that require the company to consult in advance with the SEC.<sup>8</sup>
- *Cutback priority.* Agreements should address which shares will be cut back if the SEC requires that fewer shares be registered than reflected in the initial filing. For example, the agreement may specify that cutbacks will be borne pro rata by PIPE investors and that shares underlying investor warrants will be cut back first. The cutback of warrants may increase the importance of cashless exercise provisions in the warrants to permit tacking under Rule 144.<sup>9</sup>
- *Additional registration statements.* Agreements may require follow-on registrations if needed to complete the registration of all investor shares, even if a cutback is not anticipated, as would be the case in a common stock and fixed price warrant transaction. The number of shares to be registered in the follow-on registrations may be defined in terms of existing SEC guidance (e.g., the later of sale by the investor of substantially all of the shares previously registered and six months) or, in more general terms, based on the

ability to register without SEC objection.

- *Liquidated damages.* Agreements may address the circumstances under which liquidated damages will be excused or reduced if the company is unable to register all of the investor shares by the contractual deadlines after reasonable efforts because of Rule 415-related objections made by the SEC. Such provisions may: (1) excuse liquidated damages entirely given that the cutback is not under the company's control and can be burdensome; (2) impose full liquidated damages in order to reflect that the illiquidity may not be reflected in the pricing of the PIPE; or (3) provide a grace period before liquidated damages commence that allows the company time to get shares registered but compensates investors if their liquidity is delayed past that period.

## Conclusion

Ultimately, it will be desirable for the SEC to revisit the requirements for shelf registration by smaller public companies. Because investors now have ready electronic access to SEC filings even of smaller public companies and more information must be disclosed on a current basis under the expanded Form 8-K requirements, increased availability of shelf registration for these companies can be justified. In addition, it is appropriate to recognize the liquidity needs of investors in view of the greater transparency of the trading markets for smaller public companies and the increase in trading volatility. For example, the \$75 million market capitalization requirement for primary offerings might be reduced or dispensed with if the company's shares are traded in an organized securities market or if the amount of shares being registered is limited to a prescribed percentage of the existing market capitalization. In this way, there will be less pressure on the primary v. resale secondary offering distinction, with only the need to identify selling shareholders as underwriters left at stake. In addition, a reduction in the Rule 144 holding periods (for example, to six months and one year) would mitigate the impact of investor illiquidity. Hopefully, these issues will be tackled as part of the SEC's announced plans to review regulatory impediments to small issuer financings.<sup>10</sup>

## NOTES

1. If the issuer has not been a reporting company for 12 months and is not a small business issuer, it would need to register the resale on Form S-1.

2. SEC Division of Corporation Finance, Manual of Publicly Available Telephone Interpretations, Section D, Rule 415, Interpretation No. 29, Rule 415; Form S-3 (see also, Section H, Form S-3, Interpretation No. 76, Form S-3; Rule 415):

It is important to identify whether a purported secondary offering is really a

primary offering, *i.e.*, the selling shareholders are actually underwriters selling on behalf of an issuer. Underwriter status may involve additional disclosure, including an acknowledgement of the seller's prospectus delivery requirements. In an offering involving Rule 415 or Form S-3, if the offering is deemed to be on behalf of the issuer, the Rule and Form in some cases will be unavailable (*e.g.*, because of the Form S-3 "public float" test for a primary offering, or because Rule 415(a)(1)(i) is available for secondary offerings, but primary offerings must meet the requirements of one of the other subsections of Rule 415). The question of whether an offering styled a secondary one is really on behalf of the issuer is a difficult factual one, not merely a question of who receives the proceeds. Considerations should be given to how long the selling shareholders have held the shares, the circumstances under which they received them, their relationship to the issuer, the amount of shares involved, whether the sellers are in the business of underwriting securities, and finally, whether under all the circumstances it appears that the seller is acting as a conduit for the issuer. (available at [www.sec.gov/interpst/telephone.shtml](http://www.sec.gov/interpst/telephone.shtml)).

3. For example, in a speech on February 23, 2007 at the 29th Annual Conference on Securities Regulation and Business Law in Dallas, TX, John W. White, Director, Division of Corporation Finance, US Securities and Exchange Commission, stated:

Another item of recent staff focus has been disclosure in certain so-called private investment, public equity or PIPEs offerings and whether the registered resale offering is, in substance, a primary offering by the issuer. This is an area that has drawn a lot of attention lately, principally because of the staff's concerns with convertible securities where the securities are convertible into a large number of shares of common stock relative to the issuer's outstanding shares and where there is insufficient disclosure about the market impact and cost of these transactions. In these transactions, we are not worried only about disclosure—we also are concerned about the shelf registration system being used in circumstances not intended to be covered by those rules. Our disclosure operations staff has undertaken a screening process to identify potential problematic transactions and will be seeking enhanced disclosure where appropriate. The staff's response to these transactions has also drawn attention due to the mistaken view that we are reconsidering our approach to PIPE transactions. I'll be very clear about this—the staff's view of PIPE transactions has not changed; we have simply addressed the recent development where convertible note transactions are structured in an abusive manner. (available at [www.sec.gov/news/speech/2007/spch022307jww.htm](http://www.sec.gov/news/speech/2007/spch022307jww.htm)).

4. See Current Issues and Rulemaking Projects Quarterly Update (March 31, 2001), Equity Line Financings (available at [www.sec.gov/divisions/corpfin/guidancel/ci033101ex\\_sas.htm](http://www.sec.gov/divisions/corpfin/guidancel/ci033101ex_sas.htm)).

5. See Current Issues and Rulemaking Projects Outline (November 14, 2000), Section VIII, A. 9. (available at [www.sec.gov/divisions/corpfin/guidancel/ci111400ex\\_sas\\_ppo.htm](http://www.sec.gov/divisions/corpfin/guidancel/ci111400ex_sas_ppo.htm)); see also Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations—Supplement March 1999, #3S(b) (available at [www.sec.gov/interpst/telephone/phonesupplement1.htm](http://www.sec.gov/interpst/telephone/phonesupplement1.htm)).

6. If, as a result of the SEC's guidance, flipping were to become prevalent, the SEC staff might find it necessary to tighten that guidance.

7. Rule 144 permits sales of restricted stock without registration after satisfying a one-year holding period, but such sales are subject to volume limitation, manner of sale and other restrictions under the rule. Sales are permitted without these restrictions after a two-year holding period so long as the seller is not an affiliate and has not been one for three months. PIPE investors often will be viewed as affiliates because of the number of shares they own or have the right to acquire and other control mechanisms that may be in place.

8. The approach taken may depend on the nature of the PIPE transaction. Thus, an agreement in a transaction involving common stock and fixed price warrants or other fixed price convertible securities (that is unlikely to be the focus of SEC concern) might require that all the underlying shares be registered, with provision for cutback and follow-on registration should any securities unexpectedly be excluded from the initial registration as a result of SEC objection. On the other hand, if the transaction is likely to raise SEC concerns, the amount required to be initially registered might be limited to conform to the guidance.

9. PIPE purchase documents typically allow for the cashless exercise of warrants issued to investors and placement agents, at least when the shares underlying the warrants are not covered by an effective resale registration statement. In many situa-

tions, cashless exercise permits tacking of the Rule 144 holding period. This contrasts with the exercise of the warrant for cash which creates a new holding period. Issuers sometimes resist cashless exercise provisions in PIPE warrants because they typically would prefer to receive the infusion of cash whenever a warrant is exercised.

10. See Recommendations of Advisory Committee on Smaller Public Companies to the SEC (April 23, 2006) (available at [www.sec.gov/info/smallbus/acspc-finalreport\[1\].pdf](http://www.sec.gov/info/smallbus/acspc-finalreport[1].pdf)); speech of John W. White, *supra* n. 4, at item 10 – Small Business Capital Raising and Private Offering Reform; and Letter dated March 22, 2007 from American Bar Association to John W. White on Securities Act of 1933—Private Offering Reform (available at [www.abanet.org/buslaw/committees/CL410000publcomments/home.shtml](http://www.abanet.org/buslaw/committees/CL410000publcomments/home.shtml)).

Reprinted from *Insights*, Volume 21, Number 5, May 2007, pages 2-8,  
with permission from Aspen Publishers, a WoltersKluwer Company, New York, NY  
1-800-638-8437, [www.aspenpublishers.com](http://www.aspenpublishers.com)