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Traps for the Unwary - Negotiating the Nasdaq Shareholder Approval Rules for Securities Offerings

You're planning a capital raise for a Nasdaq-listed issuer. In preparing for the offering, you review Nasdaq Rule 5635(d), which sets forth the circumstances under which shareholder approval is required. The rule seems straightforward enough - as long as the issuer is selling securities in a transaction that does not involve the issuance or potential issuance of common stock representing 20 percent or more of the outstanding common stock or 20 percent or more of the voting stock outstanding prior to the offering, no shareholder approval is required. If you are contemplating a public offering or are issuing common stock at a price in excess of the greater of book or market value, the 20 percent rule does not apply at all. However simple the rule may seem at first glance, there are several Nasdaq interpretations of Rule 5635(d) that are not necessarily intuitive and may present a minefield for the unwary. This is especially true if any of the following applies:

- The offering is an SEC-registered offering that is not a firm-commitment public offering.
- The issuer intends to make an acquisition following the conclusion of the offering using common stock as consideration.
- The offering is for convertible securities and includes a share cap with a "penalty" or "sweetener."

Basics Under Rule 5635(d), shareholder approval is required prior to issuing securities in a transaction other than a "public offering" that involves one of the following:

- The issuance or potential issuance of common stock (or securities convertible into common stock) at a price less than the greater of book or market value that, together with sales by officers, directors and 5 percent shareholders, equals 20 percent or more of outstanding common stock or 20 percent or more of the voting power of the issuer outstanding prior to issuance.
- The issuance or potential issuance of common stock (or securities convertible into common stock) equal to 20 percent or more of outstanding common stock or 20 percent or more of the voting power outstanding before the issuance for less than the greater of book or market value.

The first item to note is that Rule 5635(d) comes into play when securities are issued at less than the greater of book or market value. Since securities are frequently sold at a price that is less than current market value, many offerings will fall within the rule. In addition, this item is frequently implicated with regard to convertible securities with a "net share settlement" feature. Nasdaq takes the position that shares of common stock issued upon conversion are de facto issued at below book or market value. In calculating the number of shares issuable, all shares that could be issued in the offering are included, including any treasury shares. Again, this is especially relevant for convertible securities. For the denominator, only shares issued and outstanding are considered, which would not include treasury shares, shares held by a subsidiary and shares reserved for issuance under stock option plans or warrants. Voting power as used in the rule means the aggregate number of votes that may be cast with respect to outstanding securities and that entitle the holder to "vote generally on all matters submitted to the issuer's security holders for a vote." Accordingly, because Nasdaq specifies that a share must vote on "all" matters, securities of an issuer that has specific provisions in its charter documents limiting the voting of a particular class or series of stock to certain matters would presumably not be considered to possess voting power for purposes of the rule. In certain cases the effect of this would be to shrink the denominator, which may result in the issuance of securities in excess of the 20 percent limitation. Issuers that have multiple classes of stock with differing levels of voting power or have preferential voting securities outstanding need to carefully consider how voting power is calculated and would be well-advised to consult with Nasdaq staff prior to forming a conclusion on this issue. **What is a "public offering"?** As stated above, shareholder approval is not required, regardless of what percentage of common or voting stock is issued, or at what price, for a "public offering" of securities. However, Nasdaq takes a rather narrow view as to what type of offering constitutes a public offering for purposes of Rule 5635(d). Many practitioners would consider a public offering to exist when the securities are offered and sold pursuant to an effective registration statement filed with the SEC. These practitioners would be surprised to learn that Nasdaq does not share this view. While Nasdaq has not defined precisely what would constitute a "public offering," it has outlined several factors that it considers in making this determination. The factors include (but are not limited to) the following:

- The type of offering (i.e., firm commitment, best efforts or issuer-directed).
- The manner in which it is marketed, including the breadth of the marketing effort.
- The extent of the distribution, including whether the offering is sold to retail investors.
- The offering price and the extent of any discount.
- The extent to which the issuer controls the offering.

Generally, a fully marketed, firm-commitment public offering conducted by an underwriter and registered with the SEC (or any SEC-registered offering distributed in the same manner) will be considered a public offering by Nasdaq. However, certain offerings that don't meet these criteria may not receive the same treatment. For example, "wall-crossed" offerings made solely or primarily to institutional investors may not be considered public offerings. In this type of offering, a limited number of institutional investors are given the opportunity to participate prior to the official launch of the offering. If this approach is successful, the offering may be virtually sold out by the time of launch and the actual marketing period may last for one day or even less. Many times, retail investors have little or no participation in the offering. Nasdaq has taken the view that these offerings are not necessarily public offerings despite the fact that they are registered with the SEC and fully underwritten on a firm-commitment basis. The lack of retail involvement, short marketing period and small number of investors are all factors that weigh against the finding of a public offering. Other types of offerings that may be problematic for the purposes of Rule 5635(d) include "at the market" offerings, "registered direct" offerings, offerings not conducted on a firm-commitment basis (in particular, issuer-directed offerings) and offerings sold to investors with pre-existing relationships with the issuer. In the event that an offering exceeds the 20 percent test under 5635(d) and is anything less than a fully marketed, SEC-registered, firm-commitment offering, a call to Nasdaq staff to confirm they would view the offering as a public offering is probably wise. **Aggregation** Rule 5635(d) may also come into play if an issuer completes a nonpublic offering in proximity to a subsequent acquisition of another company in which shares of the issuer are used as consideration, even if the total number of shares issued in the offering does not exceed the 20 percent limitation. Nasdaq has taken the position that in certain circumstances, the shares issued in the offering must be aggregated with the shares issued in connection with an acquisition. Nasdaq interpretative materials provide that in determining whether to aggregate "acquisition shares" with "offering shares," Nasdaq will consider the particular facts and circumstances surrounding both transactions, including (but not limited to) these:

- The proximity of the offering to the acquisition.
- The stated use of the proceeds from the offering.

- The timing of board authorization for both the offering and the acquisition.
- Any stated contingencies in the offering or acquisition documents that relate the transactions to one another.

In a 2003 Nasdaq interpretative letter, Nasdaq indicated its determination not to integrate an issuer's private placement of 17 percent of its common stock with the issuer's pending acquisition of a target company that would result in the issuance of an additional 3.5 percent of common stock as acquisition consideration. Nasdaq made this determination even though the acquisition agreement was entered into approximately one month after the close of the private placement and the stated use of proceeds in the private placement was for working capital, general corporate purposes and strategic purposes in connection with selected acquisitions. In its interpretative letter, Nasdaq noted why it had determined not to aggregate the shares issued in the two transactions:

- The private placement and acquisition were not contingent on one another.
- At the time of the private placement, there was no definitive agreement, letter of intent or exclusive negotiation agreement with respect to the target company.
- None of the investors in the private placement would receive any consideration in connection with the acquisition (i.e., there was no commonality of investors between the transactions).

While we believe that in most circumstances shares issued in an offering and shares issued in connection with an acquisition are unlikely to be aggregated, issuers that are conducting an offering for the specific purpose of funding an acquisition or condition an acquisition on obtaining financing should carefully consider the factors listed above. **"Share caps" and "sweeteners"** Companies frequently use share caps to comply with the 20 percent limitation set forth in Rule 5635(d) in connection with the issuance of convertible securities. For example, an issuer might issue convertible securities with terms that provide the aggregate number of shares of common stock that can be issued thereby is limited to 20 percent of the current number of shares outstanding, unless shareholder approval is obtained. While Nasdaq does not prohibit the use of share caps, it has issued the following guidance regarding their use:

- If an issuer attempts to secure a later shareholder vote because it wishes to exceed the 20 percent limitation, the shares issued in the transaction requiring a vote are not eligible to vote for or against.
- Caps must apply for the life of the transaction, including if the issuer delists from Nasdaq.
- For convertible securities, if shareholder approval is not obtained, holders of the convertible securities must continue to hold the securities in unconverted form.

In contrast to caps, which are permitted under certain circumstances, Nasdaq does not permit the use of "penalties" or "sweeteners." An investor in a convertible security may be entitled to a penalty or sweetener if, following the issuance of the security, shareholder approval of conversion into voting securities in excess of 20 percent is not obtained. The penalty or sweetener may consist of a monetary penalty, increase in interest rate, increase in conversion rate, etc. Nasdaq views these arrangements as coercive to shareholders and will not accept a cap under such circumstances, and shareholder approval of the issuance of such securities may be required. **Conclusion** Nasdaq-listed issuers and their counsel are well-advised to carefully consider Rule 5635(d) prior to undertaking any offering of securities that may encroach on the 20 percent limitation. In particular, offerings that involve other than a fully underwritten, firm-commitment transaction; offerings of convertible securities; and offerings of securities that are conducted in connection with an acquisition using securities as consideration are susceptible to this rule. In many cases, clearing the terms of the offering with Nasdaq staff in advance is advisable.