

The Law

Legal and Regulatory Framework

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At almost every PIPE kick-off or organizational meeting we attend, we are asked if we can point to any authoritative written material dealing with the legal and regulatory requirements, as well as the procedures for executing PIPEs and parallel capital-raising transactions. This chapter is an effort to answer this question affirmatively. The first part deals with the legal and regulatory framework governing PIPEs and other hybrid financings, focusing on matters that are important for issuers, investment bankers, and investors. The second part presents our thoughts on best practices for executing PIPEs and other hybrid financings.

It is worth mentioning that in this chapter we use the term “PIPE” to describe only what many practitioners now refer to as a “traditional PIPE.” In 1985 we began structuring private investments in public equity. Since that time, we have seen other structures come to be described as PIPEs. The result has been confusion—people often use the term PIPE to describe no fewer than five distinct financing structures.

We discuss all of these financing methodologies as existing on a liquidity continuum—from straight private placements at one end to underwritten public offerings at the other end. Each approach has its relative advantages and disadvantages, and the challenge for practitioners is to select the optimal structure in each situation. Issuers with ongoing capital requirements and volatile stocks have found several hybrid financing methodologies to be especially helpful during market downturns.

Legal and Regulatory Framework

We begin with an overview of the legal and regulatory requirements for securities offerings. By reviewing these requirements, we can highlight the available securities law exemptions relevant to PIPEs and hybrid financings and identify some of the recurring questions clients raise in connection with them.

Registration Requirements

Section 5 of the Securities Act of 1933, as amended, sets forth the registration and prospectus delivery requirements for securities offerings. Section 5 requires, in connection with any offer or sale of securities in interstate commerce or through the use of the mails, that a registration statement must be in effect and a prospectus meeting the prospectus requirements of Section 10 of the Securities Act must be delivered prior to sale. A number of exemptions from the Section 5 registration requirements are available, based either on the type of security being offered and sold, or on the type of transaction in which the security is being offered and sold. For private placements and PIPEs, we focus on Section 5 for two basic reasons: first, to make certain that the private placement component does not run afoul of this section and inadvertently result in an unregistered public offering, resulting in a Section 5 violation; and, second, because it informs us as to how private securities ultimately may be resold.

Section 4(2)

Section 4(2) of the Securities Act provides that the Section 5 registration requirements do not apply to “transactions by an issuer not involving any public offering.”¹ The rationale for this exemption is that the extensive regulation applicable to public offerings is not required when offerings are made to a limited number of offerees that can protect themselves. Although Section 4(2) provides a statutory private placement exemption, the statute itself is of little help in determining whether any particular offering meets its requirements. Instead, issuers, underwriters, and their respective counsel must rely on judicial and administrative interpretations.

Generally, a statutory private placement involves an offering with some or all of the following elements:

- 1 a limited number of
- 2 financially sophisticated offerees
- 3 given access to information relevant to their potential investment
- 4 who have some relationship to each other and to the issuer
- 5 who are offered securities in a manner not involving any general advertising or general solicitation.

The only Supreme Court interpretation of Section 4(2) is *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). In determining whether an offering was private, the court rejected exclusive reliance on a quantitative test. Instead, the court set forth a two-part test requiring that the issuer prove that

- ❑ no offeree needs the protection afforded by registration (i.e., the investors are sophisticated), and
- ❑ each offeree had access to the kind of information that would be provided in a registration statement.

This test, referred to as the “Ralston test,” focuses on the offerees, rather than on the investors, as does Regulation D (Reg D). The person claiming the exemption must establish that the exemption is available for the particular transaction. Furthermore, because the definition of “offeree” potentially is broad, an issuer may be required to view every person with whom contact regarding the offering is made as an offeree.

The SEC and federal courts have focused on the following factors to determine whether the Ralston test is satisfied. The factors are flexible and no single factor is determinative.

❑ ***The number of offerees and their relationship to each other and to the issuer.*** This factor is significant. There is no maximum permitted number of offerees; however, the larger the number, the greater the difficulty sustaining the evidentiary burden. Offering to a large and diverse group with no preexisting relationship to the issuer suggests a public offering.

❑ ***The number of securities offered.*** The smaller the number, the less likely the offer will be deemed a public offering.

❑ ***The size of the offering.***

❑ ***The manner of offering.*** There are two general conditions: (1) the offering should be made through direct communication with eligible offerees by either the issuer or the issuer’s agent; and (2) the offering cannot include any general advertising or general solicitation.

❑ ***The sophistication and experience of the offerees.*** General business knowledge and experience usually are sufficient. Important factors to consider are education, occupation, business and investment experience, and net worth. An investor having a sophisticated representative probably satisfies this test. Alternatives to sophistication are the financial ability to bear risks (i.e., the investor’s wealth) and the existence of a special relationship to the issuer (i.e., “insider” or “privileged” status, or personal relationship).

❑ ***The nature and kind of information provided to offerees or to which offerees have ready access.*** The disclosure need not be as extensive as that in a registered offering, but must be factually equivalent. Disclosing

basic information regarding the issuer's financial condition, business, results of operations, and management is satisfactory. All information must be made available prior to sale.

❑ ***Actions taken by the issuer to prevent the resale of securities.***

Securities must come to rest in the hands of immediate investors. Premature resales of securities may be deemed a distribution and considered part of the original offering. Failure to satisfy the conditions of Section 4(2) with respect to the entire transaction will result in failing to qualify for the Section 4(2) exemption. Immediate investors that do not purchase with the requisite investment intent and that resell the securities may be deemed statutory underwriters and may be unable to rely on the Section 4(1) resale exemption.² Issuers generally take the following precautions to prevent the resale of their securities: obtain a written representation from each investor that it is acquiring the securities for investment and not with a view to distribution; place restrictive legends on the securities; and issue stop transfer orders with respect to the securities.

The nature of the securities (i.e., debt or equity) is irrelevant to the Section 4(2) exemption. The breadth of this exemption makes it useful in completing PIPEs for primary (issuer) or secondary (selling stockholder) shares, or combinations of the two.

Reg D

Reg D, promulgated by the SEC in 1982, provides issuers with a safe harbor from the Securities Act registration requirements. Reg D is intended to provide issuers with greater certainty than reliance on interpretations of the Section 4(2) exemption. However, Reg D is nonexclusive: an issuer that fails to satisfy the objective criteria of Reg D still may rely on Section 4(2). Reg D is available only to issuers and applies only to a particular transaction; resales of securities must be registered or made pursuant to another exemption.

Reg D does not exempt the issuer from, among other things, the antifraud provisions of the Securities Act, broker-dealer registration requirements, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the registration requirements of the Securities Exchange Act of 1934, or any applicable state laws relating to the offer and sale of securities.

Regardless of whether an issuer relies on Section 4(2) or Reg D, the issuer must be able to document its compliance with the relevant exemption in the following ways:

- ❑ record keeping with respect to investors
- ❑ controlling the distribution of the offering memoranda
- ❑ receiving and retaining appropriate subscription documents evidencing the nature and qualification of investors

Reg D comprises eight rules—Rules 501 through 508. Rule 501 sets forth definitions for terms used throughout Reg D. Rule 502 sets forth the general conditions relating to integration, information requirements, limitations on manner of offering, and limitations on resale. Rule 503 requires notices for sales. Rule 504 provides an exemption pursuant to Section 3(b) of the Securities Act for offerings up to \$1 million. Rule 505 provides an exemption pursuant to Section 3(b) of the Securities Act for offerings up to \$5 million. The rule most often relied on for Reg D private placements is Rule 506, the exemption for limited offerings and sales without regard to dollar amount. Although the number of “purchasers” under Rule 506 is limited to thirty-five, issuers may sell securities under Rule 506 to an unlimited number of “accredited investors.”³

Most PIPE transactions involving primary sales are structured so as to qualify for the Reg D safe harbor, usually relying on Rule 506, while also meeting the Section 4(2) private placement criteria.

Rule 501: Accredited investors

Rule 501 defines an “accredited investor” as any person who comes within any of the following categories, or whom the issuer reasonably believes comes within any of the following categories, at the time of the sale:

1 Any bank as defined in Section 3(a)(2) of the Securities Act, or any savings and loan association or other institution as defined in Section 3(a)(5)(A) of the Securities Act, whether such bank, savings and loan association, or other institution is acting in its individual or fiduciary capacity

2 Any broker or dealer registered under the Exchange Act and purchasing for its own account

3 Any insurance company as defined in Section 2(13) of the Securities Act

4 Any registered investment company or business development company

5 Any licensed Small Business Investment Company

6 Any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of \$5 million

7 Any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 (ERISA) if (i) the investment decision is made by a plan fiduciary, which is either a bank, savings and loan association, insurance company, or registered investment adviser; (ii) the employee benefit plan has total assets in excess of \$5 million; or (iii) the plan is a self-directed plan, with investment decisions made solely by persons who are accredited investors

8 Any private business development company as defined in Section 202(a)(22) of the Advisers Act

9 Any Internal Revenue Code Section 501(c)(3) exempt organization, corporation, limited liability company, Massachusetts or similar business trust, or partnership—with total assets in excess of \$5 million not formed for the specific purpose of acquiring the securities offered

10 Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer

11 Any natural person whose (i) individual net worth, or joint net worth with that person's spouse, at the time of the purchase exceeds \$1 million, or (ii) income or joint income⁴ with that person's spouse exceeds \$200,000 or \$300,000, respectively, in each of the two most recent years, and who has a reasonable expectation of reaching that same income level in the current year

12 Any trust with total assets exceeding \$5 million not formed for the specific purpose of acquiring the securities offered, and whose purchases are directed by a sophisticated person

13 Any entity in which all equity owners are accredited investors

Under Reg D, the following purchasers may be excluded when calculating the number of “purchasers” in an offering: (1) any relative, spouse, or relative of a spouse who shares the same principal residence as the purchaser; (2) any trust or estate in which the purchaser and the persons designated in (1) above have more than 50 percent of the noncontingent beneficial interests; (3) any corporation in which a purchaser and the persons designated in (1) above are the beneficial owners of more than 50 percent of the equity securities or equity interests; and (4) any accredited investor. A corporation, partnership, or other entity counts as one purchaser unless it was formed for the specific purpose of acquiring the securities offered, in which case each beneficial owner will be counted as a separate purchaser to the extent allowed in (1) above. Even if persons are excluded from the calculation of the number of purchasers, purchasers must satisfy all other applicable requirements of the exemption.

An investor that does not meet the sophistication test on its own may meet the test if the investor has authorized a purchaser representative to act on its behalf to evaluate the specific investment opportunity. A purchaser representative may not be an affiliate, director, officer, or other employee of the issuer, or a beneficial owner of 10 percent or more of any class of equity security of the issuer.

Rule 502: General conditions under Reg D

All sales that are part of the same Reg D offering must meet all of the terms and conditions of Reg D (e.g., number of purchasers and amount of offering).

□ **Integration.** Reg D cannot be used as part of a scheme to avoid registration. For example, several private placements offered within a short period of time, each relying on separate offering exemptions, may be integrated, and when taken together, may constitute a single plan of financing for which the exemption is not available. Rule 502 establishes a six-month safe harbor to avoid integration. Offers and sales made more than six months before the start or six months after the completion of a Reg D offering generally will not be considered part of the same Reg D offering. If six months have not passed, then the following factors should be considered to determine whether offerings should be integrated and considered part of the same Reg D offering:

- whether the sales are part of a single plan of financing
- whether the securities issued are of the same class
- whether the sales are made at or about the same time
- whether the issuer will receive the same type of consideration
- whether the sales are made for the same general purposes

Offers and sales of securities to foreign persons made outside the United States pursuant to Regulation S (Reg S) will not be integrated with Reg D offerings if the Reg S securities come to rest abroad. Integration issues are discussed in more detail later in this chapter.

□ **Information requirements.** If an issuer is selling securities only to accredited investors or selling securities pursuant to Rule 504 (raising up to \$1 million), there are no specific information requirements. If an issuer is selling securities to nonaccredited investors or raising in excess of \$1 million, the issuer must comply with information requirements set forth in Rule 502. The information requirements for issuers that do not have a class of securities registered under the Exchange Act vary depending on the dollar amount being raised.

Nonaccredited investors participating in an offering under Rule 505 or Rule 506 also must be furnished a written description of any written information provided to any accredited investor at a reasonable time prior to their purchase and, upon written request, the actual information. These investors also must be given the opportunity to ask questions concerning the terms and conditions of the offering and to obtain any additional information the issuer possesses or can acquire without unreasonable effort or expense.

Although there is a specific required level of disclosure for sales of securities to nonaccredited investors, no such requirement exists for sales

to accredited investors. Nonetheless, when selling securities to both accredited and nonaccredited investors, issuers should consider providing the same disclosure to each in light of the antifraud provisions of the Securities Act.

□ ***Manner of offering.*** Neither the issuer nor any person acting on its behalf is permitted to offer to sell securities by any form of general solicitation or general advertising, including, but not limited to (1) any advertisement, article, or other published or broadcast communication; or (2) any seminar or meeting whose attendees have been invited by general solicitation or advertising.

A fundamental factor in determining whether a solicitation or advertisement is general or limited is the existence of a preexisting relationship between the offerees and the issuer and any person acting on the issuer's behalf. The theory is that a preexisting relationship helps to ensure that, prior to any offer, the offeror will be in a position to know whether a proposed offeree has the requisite financial and business knowledge and experience.

The content of an advertisement, article, notice, or other communication is crucial to a decision regarding its use to offer or sell securities pursuant to Reg D. Generally, a generic solicitation that does not reference any investment currently offered or contemplated is appropriate. Although more specific information also can be acceptable, the issuer must take steps to ensure that an offeree understands that no formal offers will be accepted prior to the receipt by the offeree of a complete disclosure document and the issuer's determination that the offeree is an appropriate investor. With regard to the "prior relationship" issue, the SEC took the view that Rule 502 does not require offerees to have invested previously in securities through the broker-dealer participating in the offering in question. The SEC held that substantive relationships might be established with persons who have provided the offeror with sufficient information to evaluate the prospective offeree's sophistication and financial circumstances. The use of an investor questionnaire is only one way to establish and demonstrate substantive relationships. A firm's prior dealings with a client also may give a firm the access required to evaluate that person's sophistication without the formality of a questionnaire.

The fact that a solicitation is directed only to accredited investors will not ensure that the solicitation has been made in compliance with Rule 502, because Rule 502 relates to the nature of the offering rather than the nature of the offeree.

Rule 135c promulgated under the Securities Act permits an issuer that files reports under the Exchange Act to publish a notice concerning an unregistered securities offering. A 135c notice is not considered a sollicita-

tion or advertisement for purposes of Rule 502 so long as the notice is not issued in order to condition the market.

□ **Limitations on resale.** Securities acquired in a Reg D private placement are restricted securities and cannot be resold without registration under the Securities Act or pursuant to an available exemption. The issuer must exercise reasonable care to ensure that the purchaser of the securities is not deemed a statutory underwriter under the Securities Act. Reasonable care can be demonstrated by

- making reasonable inquiry of the investor regarding its intent (i.e., investor questionnaires and representations)
- written disclosure as to transfer restrictions on restricted securities
- placing restrictive legends on certificates

Rule 503: Notice

An issuer relying on Reg D must file a notice on Form D with the SEC no later than fifteen days after the first sale of the securities. If sales are made under Rule 505, the notice must contain an undertaking by the issuer to furnish, at the SEC's request, the information the issuer furnished to nonaccredited investors. Issuers that fail to file a required Form D are disqualified from making additional Reg D offerings.

Rule 504: Exemption for offerings and sales up to \$1 million

Rule 504 provides an exemption for offerings and sales of securities of up to \$1 million in any twelve-month period by issuers that are not reporting companies, investment companies, or blank check companies. Offerings may be made to any number of accredited or nonaccredited investors. Rule 504 does not prescribe specific information requirements. The manner of sale requirements of Section 502 and the resale restrictions of Rule 144 (see the discussion on page [116]) will not apply to Rule 504 offerings if (1) the transactions are registered under a state law requiring public filing and delivery of a disclosure document to investors before sales are made, or (2) the securities are issued under a state law exemption permitting general solicitation and advertising and the sales are made only to accredited investors.

Rule 505: Exemption for offerings and sales up to \$5,000,000

Rule 505 provides an exemption for offerings and sales of securities of up to \$5 million in any twelve-month period by issuers (other than investment companies or issuers that would be disqualified by Rule 252 promulgated under the Securities Act from using Regulation A) to an unlimited number of accredited investors and up to thirty-five nonaccredited investors. If there are nonaccredited investors, the offering must meet all of the conditions in Rules 501 and 502, including the information requirements.

Rule 506: Exemption for limited offers and sales without regard to dollar amount

Pursuant to Section 4(2), Rule 506 provides an exemption subject to the following conditions: The conditions in Rules 501 and 502 must be met; there are no more than, or the issuer reasonably believes there are no more than, thirty-five “purchasers” and an unlimited number of accredited investors; and the issuer must reasonably believe that each nonaccredited investor must, either alone or with his purchaser representative, have such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment.

Rule 508

Failure to comply with a term, condition, or requirement of Rules 504, 505, or 506 will not result in loss of an exemption for any offer or sale to a particular individual or entity if the person relying on the exemption shows that

- ❑ the failure to comply did not pertain to a term, condition, or requirement directly intended to protect that particular individual or entity;
- ❑ the failure to comply was insignificant with respect to the offering as a whole; or
- ❑ a good faith and reasonable attempt was made to comply with all applicable terms, conditions, and requirements of Rules 504, 505, or 506.

The provisions of Reg D relating to the manner of offering, the dollar limits of Rules 504 and 505, and the limits on nonaccredited investors in Rules 505 and 506 are deemed significant to every offering and, therefore, are not subject to this defense.

State blue-sky issues. Under the federal preemption doctrine and the National Securities Market Improvement Act of 1996 (NSMIA), securities exempt from registration under a federal securities law exemption, including pursuant to rules promulgated under Section 4(2) of the Securities Act, are exempt from registration under state securities laws. Therefore, securities offered pursuant to Rule 506, promulgated under Section 4(2), are exempt from state securities registration requirements. NSMIA allows the state to require the filing of a Form D, a consent to service of process, and a filing fee as established by rule and to require such filing at the same time and manner as required by the SEC with respect to a Rule 506 offering or fifteen days after a sale is made to an investor within a jurisdiction. Rules 504 and 505 were promulgated under Section 3(b) of the Securities Act and do not preempt state securities law requirements. As a result, secu-

rities offered pursuant to Rules 504 and 505 are subject to state securities law registration.

Other private placement exemptions. A number of other private placement exemptions may be available under certain circumstances but are relied upon less frequently than Section 4(2) and Reg D. Section 4(6) provides an exemption from registration for offerings of up to \$5 million made solely to accredited investors. Rule 701 provides an exemption for securities awarded by nonreporting companies to employees, consultants, and others as part of a compensatory arrangement. Rule 1001 provides an exemption for offerings that qualify for a California state private placement exemption. Regulation A provides an abbreviated offering methodology for issuers seeking to raise up to \$5 million in a twelve-month period.

Rule 144A

Rule 144A provides investors with a methodology for reselling certain securities without registration. We think of Rule 144A as a limited exemption or safe harbor from the Section 5 registration requirements, one that permits persons other than the issuer to resell, in a transaction not involving a public offering, restricted securities acquired from the issuer. Rule 144A requires that the restricted security be sold (without limitation as to number) to persons the seller reasonably believes to be qualified institutional buyers (QIBs); that the securities were not, when issued, of the same class as securities listed on a national securities exchange or quoted on an automated interdealer quotation system; that the investor is aware that the seller is relying on Rule 144A for its resale; and that the issuer either is a reporting company under the Exchange Act or makes available certain information to holders. Sales to QIBs made in reliance upon Rule 144A are not distributions, and the seller in a 144A sale is not considered an underwriter.

QIBs. The rule identifies certain institutions that are considered QIBs—including insurance companies; registered investment companies; licensed small business investment companies; certain pension plans; registered investment advisers; and certain banks, savings and loan associations, and trust funds. Generally, QIBs must meet specific financial thresholds. Any entity that owns and invests on a discretionary basis at least \$100 million in securities of nonaffiliates, even if the entity was formed to acquire restricted securities, is considered a QIB. Banks and thrifts also must have an audited net worth of at least \$25 million. Registered securities dealers need only own and invest on a discretionary basis \$10 million in securities of nonaffiliates, and they may execute no-risk principal transactions for QIBs without regard to the amount owned and invested. Any entity of which all equity owners are QIBs is deemed to be a QIB.

A seller must reasonably believe that the buyer is a QIB. Rule 144A provides several alternatives for ascertaining QIB status, including reliance on a buyer's annual financial statements, filings by the buyer with a United States or foreign governmental agency or self-regulatory organization, or a certification by an executive officer of the buyer as to satisfaction of the financial tests. There is no duty to verify the certification.

Eligible securities. Rule 144A is not available for transactions in (1) securities that, when issued, were of the same class as securities listed on a national securities exchange or quoted on an automated interdealer quotation system (e.g., Nasdaq); or (2) securities of an open-end investment trust or face amount certificate company. Preferred equity and debt commonly viewed as different series generally will be viewed as different, nonfungible classes for purposes of Rule 144A. Convertible or exchangeable securities are treated as the underlying security unless subject to an effective call premium of at least 10 percent. The SEC staff's position is that securities that are convertible or exchangeable at the issuer's option are fungible if the underlying security is fungible, regardless of the "effective conversion premium." This is based upon the notion that the "investment decision" for the fungible security is made at the same time as the investment decision for the convertible or exchangeable security. Warrants are treated as the underlying security unless the warrant has a term of at least three years and an effective exercise premium of at least 10 percent.

Information requirements. An issuer that is not an Exchange Act-reporting person or an exempt foreign issuer must comply with the information requirements of Rule 144A in order for the Rule 144A safe harbor to be available to its security holders. The holder and the prospective investor have the right to receive from the issuer, and the prospective investor must have received from the issuer or the seller, the following information: a "very brief" description of the issuer's business and financial statements for the most recent fiscal year and, if the issuer was in existence, for the preceding two years, audited if reasonably available. Rule 144A does not provide how the security holder's "right to obtain" the required information must be established. However, the SEC has confirmed that such a right can be created in the terms of the security, by contract, by operation of law, or by the rules of a self-regulatory organization.

Notice requirement. A seller must take reasonable steps to ensure that the buyer is aware the seller may rely on Rule 144A.

Resales under Rule 144A. Securities acquired pursuant to a Section 4(2) offering or a Reg D offering may be immediately resold under Rule 144A. The intent to resell under Rule 144A is not inconsistent with Section 4(2) or Reg D. As a result, Rule 144A transactions may be structured as agency or principal transactions. In the case of a principal transaction,

an investment bank, acting as initial purchaser, will agree to purchase on a firm commitment basis in a private placement an entire issue of unregistered securities; the investment bank then immediately resells the securities to QIBs. This is possible because purchasing from an issuer with a view to reselling under 144A will not affect the availability to the issuer of the Section 4(2) or Reg D exemption.

Regulation S

Section 5 of the Securities Act prohibits any person from using interstate commerce in connection with the offer or sale of a security unless a registration statement is in effect with respect to such security. Theoretically, interstate commerce may include trade or commerce in securities between the United States and a foreign country, meaning that securities transactions with only tenuous links to the United States could be subject to registration requirements. However, the SEC views Section 5 as a protection for U.S. investors, and, prior to the adoption of Reg S, stated in releases that securities offered or sold outside the United States would not be subject to these registration requirements if precautions were taken to ensure that the securities came to rest abroad. Because interpretations of these SEC releases were unclear, the SEC adopted Reg S.

Reg S clarifies the SEC's position that securities offered and sold outside of the United States need not be registered with the SEC and specifies two safe harbors—an issuer safe harbor (Rule 903) and a resale safe harbor (Rule 904)—which provide that offers and sales made in compliance with certain requirements are deemed to have occurred outside the United States and are, therefore, excluded from the application of Section 5. There are two general conditions for the issuer and resale safe harbors: Any offer, sale, or resale must be made in an offshore transaction (as defined in Reg S); and no directed selling efforts (as defined in Reg S) may be made in the United States in connection with an offer, sale, or resale under the safe harbors.

Issuer safe harbor. The issuer safe harbor is available to all issuers, distributors, and their affiliates. Rule 903 of Reg S specifies three categories of permissible issuer offerings and imposes different safeguards for each category to prevent securities offered abroad from flowing back into the United States. Issuers must comply with offering restrictions, including imposition of a “seasoning” or compliance period, varying from a forty-day period for debt securities to a one-year period for equity securities, during which offering participants are subject to stringent transfer restrictions.

Resale safe harbor. Resales by (a) any persons other than the issuer, a distributor, or their respective affiliates, and (b) any officer or director

of the issuer or a distributor, who is an affiliate of the issuer or distributor solely by virtue of holding such position, are deemed to have occurred outside the United States if the two general conditions, plus any applicable additional resale requirements, are met. The resale safe harbor is available for all securities, whether or not acquired in an offshore transaction. For example, securities originally sold under a private placement exemption may be resold outside the United States under Rule 904 without affecting the validity of the original transaction.

Resale limitations. Rule 905 was adopted to remedy abusive practices under Reg S. The rule states that equity securities of domestic issuers acquired from the issuer, a distributor, or their respective affiliates in a transaction subject to the conditions of Rule 901 or 903 are “restricted securities” within the meaning of Rule 144. As a result, an offshore investor can resell such securities only in accordance with Reg S, pursuant to a registration statement, or pursuant to an applicable exemption from registration. Restricted securities that are equity securities of a domestic issuer will continue to be deemed restricted securities, notwithstanding that the securities were acquired in a Rule 901 or Rule 904 resale transaction. After the relevant compliance period, securities offered and sold outside the United States pursuant to Reg S may be resold under Sections 4(1) and 4(3) of the Securities Act or pursuant to another applicable exemption.

Contemporaneous private placement in the United States and Reg S offering. In determining whether the offshore transaction requirement has been satisfied, a contemporaneous registered offering or exempt private placement in the United States will not be integrated with an offshore offering that otherwise complies with Reg S. In determining whether the requirements for an exempt private placement under Section 4(2) have been satisfied, offshore transactions made in compliance with Reg S will not be integrated with domestic offerings that are otherwise exempt from registration under the Securities Act.

Resales of Restricted Securities

Restricted securities are securities acquired in a transaction not involving a public offering for purposes of the Securities Act. Restricted securities must be sold either pursuant to a registration statement or pursuant to another available exemption. Generally, Section 4(1) exempts from registration “transactions by any person other than an issuer, underwriter, or dealer.” This exemption alone should make it possible for most investors to resell their restricted securities without registration. However, Section 2(11) of the Securities Act defines an “underwriter” as any person who has purchased securities from the issuer with a view to, or who offers or sells for an issuer

in connection with, the distribution of any security. For these purposes, an “issuer” includes a “control person” or “affiliate.”

Persons who have purchased securities in a private placement directly from an issuer or directly from an affiliate, and who wish to resell the securities, may be deemed to have purchased securities with a view to a distribution and, as a result, may be considered “underwriters.” An affiliate selling either restricted or nonrestricted securities faces a similar problem. The affiliate may not be able to invoke an exemption in a resale of those securities because the affiliate also may be deemed to be acting as an “underwriter.” If an investor is deemed to be an underwriter, certain liability provisions of the Securities Act may become applicable.

Rule 144⁵

Rule 144 has been called the “dribble-out rule” because it permits investors (often affiliates) to sell limited quantities of securities acquired in private transactions over a protracted period of time. More precisely, Rule 144 provides a safe harbor for investors selling restricted securities without registration. Rule 144 also applies to sales of securities by affiliates of the issuer regardless of whether such securities were acquired in a public offering.⁶ If an investor and a broker make a sale in compliance with the conditions set forth in Rule 144, they will be deemed to be neither underwriters nor engaged in a distribution and may sell the securities without registration.

To comply with the requirements of Rule 144, the following conditions must be met:

Adequate current public information. There must be adequate current public information regarding the issuer. An issuer meets the adequate current public information requirement of Rule 144(c) if

❑ The issuer has securities registered under the Securities Act or the Exchange Act, has been subject to the SEC’s reporting requirements for at least ninety days prior to the sale, and has filed all Exchange Act reports required to be filed during the twelve months preceding the sale (or for such shorter period that the issuer was required to file reports); or

❑ The issuer is a nonreporting company that meets the informational requirements of Rule 15c2-11.

Holding period. Under Rule 144(d), an investor seeking to sell restricted securities must meet a one-year holding period requirement. In computing the one-year holding period, holding periods of owners may be combined with holding periods of predecessor owners unaffiliated with the issuer. This is known as “tacking.” Tacking also is permitted in certain instances in which the predecessor owner is an affiliate.

Securities offered and sold in a registered public offering are not restricted securities. Thus, the provisions of Rule 144 need not be followed for those securities, assuming the holder is not an affiliate. However, the mere registration of certain securities transactions does not change the status of unregistered securities of the same type. For example, following a registered public offering, an investor could hold both registered securities and restricted securities of the same type. The registered securities could be sold freely, assuming the holder is not an affiliate, whereas sale of the restricted securities would continue to require compliance with Rule 144 or registration.

Volume limitations. Rule 144(e) restricts the amount of securities a person can sell during any three-month period to the greater of (1) 1 percent of the outstanding securities of the class being sold, or (2) the average weekly trading volume for the class during the four-week period preceding the sale. For affiliates, the volume limitations always apply to both restricted and unrestricted securities.

Manner of sale. Securities sold pursuant to Rule 144 must be sold either in unsolicited “brokers transactions” or in transactions directly with a market maker. Brokers transactions include transactions by a broker in which such broker does no more than execute the order to sell for the usual and customary broker’s commission and does not solicit orders to buy the securities (with certain exceptions). In addition, the investor may not solicit or arrange for the solicitation of orders to buy the securities and may not make any payment in connection with the offer or sale except to the broker that executes the order to sell the securities.

Form 144. If, during any three-month period, an investor proposes to sell, in reliance on Rule 144, an amount of securities exceeding 500 shares or other units or securities having an aggregate value in excess of \$10,000, the investor must file a Form 144 with the SEC and any securities exchange on which the securities are listed.

Sales by nonaffiliates. Rule 144(k) allows nonaffiliates to sell restricted securities held for more than two years without regard to the foregoing restrictions so long as such person has been the beneficial owner of the securities for at least two years prior to the sale and has not been an affiliate of the issuer for three months prior to the sale.

Sales by affiliates. All sales of securities by an affiliate are subject to Rule 144. However, sales of securities acquired by an affiliate in a registered public offering are not subject to the holding period requirement, but are subject to the other requirements of Rule 144, including the requirement that the issuer have been a reporting company for ninety days.

Executing Private Placements, PIPEs, and Other Hybrid Transactions

Private placements to institutional or accredited investors take many forms and differ greatly depending upon whether they are conducted by private companies or public companies. In either case, most private placements will be made in reliance on Section 4(2) and/or Reg D.

Private Placements

An issuer undertaking a private placement generally engages the services of an investment bank to serve as its agent and make introductions to potential investors. The issuer typically works with the agent and issuer's counsel to produce a private placement memorandum and a detailed term sheet describing the securities to be offered. For a private company, preparation of the private placement memorandum may be a complex task, because it may be the first time the issuer has had to describe its business. For a public company, the private placement memorandum may be no more than a collection of its publicly filed documents.

The placement agent contacts potential investors. This process may take several months. A lead investor or a group of lead investors typically dominates and shapes the process through completion of the transaction. Lead investors conduct their own fairly extensive due diligence investigation, often involving meetings with the issuer's executive officers, as well as a thorough review of the issuer's organizational documents and material contracts. Counsel for the lead investors negotiates a term sheet and provides the issuer and its counsel with a draft purchase agreement based on the negotiated term sheet.

The purchase agreement contains extensive issuer representations and warranties, as well as investment representations from the investors. Depending on market conditions and the issuer's maturity, business, financial condition, and prospects, the lead investors may negotiate various ongoing affirmative and negative covenants. These may include covenants regarding maintenance of existence; compliance with applicable laws; limitations on mergers, consolidations, and asset sales; restrictions on the use of asset sale proceeds; delivery of regular financial information; board representation; blocking rights; antidilution protection; registration rights; and financial covenants (such as limitations on indebtedness, limitations on liens, limitations on subsidiary debt, or a net interest or cash flow coverage test). Once the lead investors have negotiated the purchase agreement and other investment documents, the documents are circulated to other potential investors for their review. Counsel for the investors collects and coordinates these comments.

Advantages and Disadvantages of a Private Placement

The process is likely to be time-consuming and expensive for the issuer. Because the securities being sold are restricted securities, they will be sold at a robust discount to the then-current market price (assuming there is a market for the securities). Investors will have negotiated for themselves registration rights, which may include demand as well as piggyback rights; however, these registration rights are likely not to require the issuer to file a registration statement immediately. Most investors purchasing in a private placement are committed holders of the securities who also may want representation on the issuer's board of directors and a measure of control over certain of the issuer's activities.

A private placement provides additional capital for growth and may permit the issuer to diversify its investor base. For a public company, a private placement may be attractive, especially in volatile markets, and will not require registration with the SEC or immediate disclosure to the public upon its commencement.

Financing Alternatives

An issuer may conduct a private placement at the same time it conducts a Reg S offering, or at the same time as, or in conjunction with, a Rule 144A offering. A Reg S offering would not be "integrated" with the private placement and would attract offshore investors. For an issuer that requires significant funds (typically at least \$100 million), a contemporaneous Rule 144A offering of a different security (a security not of a class listed on a national securities exchange) would attract a different investor base, might offer better pricing given the improved liquidity associated with a Rule 144A offering (compared to a private placement), and usually would not contain financial covenants. Similarly, the issuer may consider a combined Rule 144A/Section 4(2) offering. If the issuer is public and requires significant cash, it might consider a stand-alone Rule 144A offering. In a Rule 144A offering, the agent or financial intermediary may act as initial purchaser or may facilitate introductions to QIBs. An "underwritten" or firm commitment 144A offering with the placement agent acting as initial purchaser may be an attractive option.

Private Placements with Trailing Registration Rights

A public issuer considering a financing may prefer a private placement with "trailing" registration rights to a straight private placement. A private placement with trailing registration rights frequently is referred to as a PIPE, because it is literally a private investment in public equity; however, as described later in this chapter ("Traditional PIPEs"), we refer to a PIPE more narrowly as a specific and different transaction format.

The process. In a private placement with trailing registration rights, the issuer generally engages an investment bank to act as its agent to introduce it to potential investors. The placement agent has no commitment to purchase any of the securities and, indeed, cannot purchase any securities. The issuer works with the placement agent and issuer's counsel to prepare a private placement memorandum and draft subscription documents. The issuer may produce a detailed private placement memorandum or may take the more common approach of using a simplified private placement memorandum consisting primarily of the issuer's publicly filed documents.

Typically, the placement agent rather than a lead investor controls the investment process. The placement agent may arrange a series of road show presentations for the issuer's executive officers or a series of smaller meetings with potential investors scheduled over a period of a few days to a few weeks. Potential investors may rely on the placement agent to conduct a due diligence investigation and are likely to limit their own diligence investigation to conference calls with the issuer's executive officers and a review of the private placement memorandum. The placement agent takes indications of interest from potential investors. Potential investors review the subscription documents provided by the issuer and the placement agent. The subscription agreement contains issuer representations and warranties, but generally contains few covenants. The subscription agreement typically is not highly negotiated. All investors sign the same form of subscription agreement.

Basic terms. Investors in a private placement with trailing registration rights are looking for enhanced liquidity. They may or may not be long-term holders. Investors focus their attention on the issuer's representations and warranties and on the issuer's registration obligations. The issuer agrees to make available, within a short time following completion of the transaction, a resale registration statement covering the resale from time to time of the securities purchased by the investors. The issuer usually will negotiate for a period of between forty-five and ninety days during which it must file the resale registration statement. The subscription documents also specify a number of days during which the issuer must seek to have the resale registration statement declared effective. Many subscription agreements require that the issuer make penalty payments to investors if it fails to meet any of the deadlines for filing or effectiveness. The penalty payments may be payments in cash or additional securities. If the penalty provisions require delivery of additional securities to investors, the subscription document also requires registration of the additional securities. Registration rights and penalty payments are discussed in more detail in Chapter 6, "Fundamental PIPEs: Typical Structures and Transactions."

An issuer that has undergone significant organic changes, such as an acquisition, disposition, merger, or restructuring, may wish to negotiate longer periods (perhaps up to 120 days) to file and have declared effective the resale registration statement, because it may require additional preparation time and the resale registration statement has a higher likelihood of SEC review. Investors may extract higher discounts in exchange for longer filing periods, given that investors will bear the risks associated with holding illiquid securities longer. By contrast, an issuer that has prepared a draft resale registration statement in advance of completing the private placement may benefit (receiving better pricing) from agreeing to reduced periods (for example, five to ten days from closing to file, and forty-five days to seek effectiveness, of the resale registration statement).

The resale registration statement must be kept effective for at least two years to cover resales by investors until shares are eligible to be sold pursuant to Rule 144(k). During this two-year period, the issuer may suspend (or black out) the use of the registration statement because the registration statement must be amended or corrected to remedy a material misstatement or omission. During a blackout period, investors have limited liquidity, as they will not be able to avail themselves of the resale registration statement to resell their securities. As a result, investors negotiate limits on blackout periods in the subscription documents. In turn, issuers may attempt to preserve their flexibility with respect to blackout periods, especially because it is difficult for an issuer to anticipate whether in the future it will be forced to black out its registration statement as a result of a material transaction or other significant event.

A private placement with trailing registration rights may involve common stock, preferred stock, or convertible securities. If convertible securities are sold, the resale registration statement covers the underlying shares rather than the convertible securities. We discuss below some of the issues arising in connection with registering shares underlying convertible securities or penalty shares. Chapter 6 also addresses issues specific to convertible securities.

Advantages and disadvantages of a private placement with trailing registration rights. For a public company, a private placement with trailing registration rights may be a more attractive financing alternative than a straight private placement or than a traditional PIPE. Because investors receive resale registration rights, providing them with increased liquidity, the issuer likely will receive better pricing than in a straight private placement. Investors may be sector investors interested in holding the issuer's stock long term or financial buyers interested in a short-term investment. Nonetheless, neither investor group is likely to negotiate ongoing affirmative and negative operating and financial covenants, except

in distressed situations. The issuer's ongoing obligations are limited to maintaining effectiveness of the resale registration statement. Both the marketing process and the negotiation of documents are shorter for a private placement with trailing registration rights than for a straight private placement. Unlike in a traditional PIPE, the investors will fund and the transaction will close once the subscription agreement has been negotiated. Consequently, the issuer receives its funds quickly, usually within two weeks of commencing the process.

Resale registration statement. Following closing, the issuer prepares and files with the SEC a resale registration statement. In contrast to a traditional PIPE, the closing does not depend upon the SEC review process. If the issuer has been public for at least one year, it is likely to be eligible to use a registration statement on Form S-3 on a resale basis. An issuer need not be S-3 eligible on a primary basis in order to complete a private placement with trailing registration rights or a traditional PIPE. In order to use Form S-3 for resales (to register secondary shares):

1 An issuer must

- be organized in the United States
- have a class of securities registered pursuant to Section 12(b) of the Exchange Act or a class of equity securities registered pursuant to Section 12(g) of the Exchange Act, or be required to file reports pursuant to Section 15(d) of the Exchange Act
- have been public and have timely filed all required filings for a period of at least twelve calendar months immediately preceding the filing of the Form S-3

2 The issuer, and its consolidated and unconsolidated subsidiaries, must not, since the end of the last fiscal year for which certified financial statements of the issuer and its consolidated subsidiaries were included in an Exchange Act report:

- have failed to make any required dividend or sinking fund payment on preferred stock
- have defaulted on the terms of any borrowing or on any long-term lease, which defaults in the aggregate are material to the financial position of the issuer and its consolidated and unconsolidated subsidiaries, taken as a whole

Using an S-3 is cheaper and less time-consuming for the issuer than using a Form S-1 or a Form S-2. An S-3 is less burdensome for the issuer because it may be updated by the periodic filing of the issuer's Exchange Act reports, without filing post-effective amendments to keep the registration statement current. If an issuer is not eligible to use an S-3, it may file a resale registration statement on an S-1 or an S-2. Both Form S-1 and S-2

require the issuer to file post-effective amendments to keep such registration statements current. An issuer also may convert an S-1 or S-2 to an S-3 by the filing of a post-effective amendment when the issuer becomes eligible to use Form S-3.

Investor representations. An investor who purchases securities in a private placement with trailing registration rights receives restricted securities. The securities contain a restrictive legend and the issuer may keep a stop transfer order in effect. The investor is asked to make investment representations in the subscription agreement. In addition to making representations as to its status as an institutional or an accredited investor, the investor also represents that it is acquiring the securities for investment purposes with an intent to hold rather than with a view to a distribution. Frequently, if the purchase price is subject to adjustment based on the issuer's stock price during the days immediately prior to consummation of the private placement, the investor also is asked to make additional representations to the effect that it has not shorted (or otherwise directly or indirectly hedged its interest in) the securities and to covenant that it will not engage in any hedging transactions. We discuss hedging considerations in connection with private placements later in this chapter.

Subsequent transfers. The investor may transfer or resell the securities only pursuant to the resale registration statement or pursuant to an exemption from registration. Because the securities will bear a legend, the investor (or the investor's broker) is required to contact the issuer's transfer agent to request that the transferee receive securities free of legend (if the transferee is purchasing the securities pursuant to the resale registration statement). The transfer process may be cumbersome and time-consuming. In fact, it may delay settlement of a trade. For these reasons, investors may negotiate with the issuer specific transfer procedures. An issuer may work with the transfer agent to have on file procedures, with detailed time lines, to facilitate efficient transfers.

Engagement letters for a private placement with trailing registration rights. Generally, a placement agent retained to advise in connection with a private placement enters into an engagement letter with the issuer. The engagement letter outlines the agent's obligations in connection with the financing. These include assisting in preparing the private placement memorandum, assisting in preparing a road show or investor presentation, and, of course, introducing the issuer to potential investors. The engagement letter sets forth the fees to be paid to the placement agent for its activities and the terms and conditions of payment. The agent and issuer may consider carving out from the fee arrangement monies raised from the issuer's "friends and family" or from other investors previously con-

tacted by or known to the issuer. This may be accomplished most easily by identifying specific investors that fall into this latter category. A placement agent often negotiates for itself a “tail,” affording the agent the right to receive a fee in respect of future financings, especially other private placements, completed by the issuer during some set period. A placement agent also may negotiate a right of first offer or a right of first refusal to participate in future financings or to serve in a financial advisory capacity. The terms and arrangements between placement agents and issuers vary greatly. These arrangements (unlike those entered into in connection with public offerings) are not subject to NASD review. Nevertheless, the arrangements will be disclosed by already-public companies in their periodic reports or in a resale registration statement, to the extent that the placement agent receives securities as part of its compensation. Any securities issued to the placement agent may “count” for purposes of the various stock exchange limitations on stock issuances requiring shareholder approval. The engagement letter also describes the offering procedures and sets forth the issuer’s indemnification obligations.

Traditional PIPEs

The term PIPE generically refers to any private placement of securities of a public company made to selected accredited investors (usually to institutional investors) wherein investors enter into a purchase agreement committing them to purchase securities and, usually, requiring the issuer to file a resale registration statement covering the resale from time to time of the securities purchased in the private placement. As discussed previously, a number of transaction types, having very different characteristics and raising different concerns for issuers, investors, and financial intermediaries, all may be characterized as PIPEs:

- the sale of common stock at a fixed price
- the sale of common stock at a fixed price, together with fixed-price warrants
- the sale of common stock at a fixed price, together with resettable or variable-priced warrants
- the sale of common stock at a variable price
- the sale of convertible preferred stock or convertible debt

Most traditional PIPE transactions involve the issuance of common stock, whereas most structured PIPE transactions (discussed briefly below and in more detail in Chapter 3, “A Historical Perspective: The Bubble, Converts, and the Birth of Structured PIPEs”) involve the issuance of convertible securities or preferred stock. A traditional PIPE may involve newly issued company shares (primary shares), shares held by selling stockhold-

ers (secondary shares), or a combination of primary and secondary shares of a public company.

A PIPE transaction offers an issuer significant advantages:

- lowered transaction expenses
- expanded institutional investor holdings
- in fixed-price transactions, reduced incentive for investors to hedge their commitment by shorting the issuer's stock
- required disclosure of the transaction to the public only after definitive purchase commitments are received from investors
- required preparation by the issuer only of very streamlined information, including publicly filed Exchange Act reports
- ability of issuer to close and fund a transaction within seven to ten days of receiving definitive purchase commitments

Basic terms. Investors in a traditional PIPE irrevocably commit to purchase a specified number of securities at a fixed price, with the closing conditioned upon, among other things, the SEC's preparedness to declare effective a resale registration statement covering the resale from time to time of the securities sold in the private placement. In a traditional PIPE, the investor bears the price risk from the point of pricing, when the purchase agreement is executed, until closing, when funding occurs. The issuer is not obligated to deliver additional securities to the PIPE investors in the event of stock price fluctuations or otherwise. In fact, once the purchase agreement is executed and the issuer files the resale registration statement, no changes may be made. Investors do not fund when they execute the purchase agreement. Instead, after execution of the purchase agreement, the issuer files a resale registration statement covering the resale of the securities by the PIPE investors. The transaction closes and investors fund once the SEC has indicated its preparedness to declare effective the resale registration statement. In this manner, investors are assured at the time of funding that a resale registration statement will be effective and available for their use.

Traditional PIPE investors generally do not negotiate for themselves ongoing negative covenants or covenants relating to information rights or corporate governance. Thus, basic terms generally include the following:

- standard representations and warranties (similar to those contained in an underwriting agreement) that must be brought down at closing
- delivery to the placement agent of a comfort letter and legal opinions (including a 10b-5 negative assurance relating to the private placement memorandum and the resale registration statement)
- before an investor obtains unlegended stock certificates, delivery by

- the investor to the issuer and the transfer agent of a certificate as to the investor's compliance with the prospectus delivery requirement
- closing conditions limited to (1) no occurrence of any material adverse change between execution and closing, and (2) the SEC's willingness to declare effective the resale registration statement

Satisfaction of the closing conditions is outside of the investor's control. This is essential to ensure that the PIPE is a valid private placement. A traditional PIPE is conducted in reliance on Section 4(2) and/or Reg D. Rule 152, promulgated under the Securities Act, provides that "the phrase 'transactions by an issuer not involving any public offering' in Section 4(2) shall be deemed to apply to transactions not involving a public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement." The SEC has applied Rule 152 to its analysis of traditional PIPE offerings, reasoning that if (1) the initial sale or placement of the securities in the traditional PIPE is conducted in a manner consistent with a private placement (i.e., no general solicitation or advertising and offerings made principally to accredited investors), and (2) such investors enter into definitive commitments to purchase the securities, which commitments are subject only to the satisfaction of conditions outside of their control and expose the investors to the risk of holding the restricted securities (price risk), then the filing of the resale registration statement prior to funding or closing of the PIPE transaction is consistent with Rule 152 and does not, as to the existing PIPE transaction, constitute a general solicitation. The SEC staff also addressed these concepts in several no-action letters, including *Black Box Incorporated* (avail. June 26, 1990) and *Squadron, Ellenoff, Pleasant & Leher* (avail. February 28, 1992). We discuss these later in this chapter under the heading "Integration Issues."

SEC guidance. The SEC staff has provided additional guidance through its discussions in the Corporation Finance Division's *Manual of Publicly Available Telephone Interpretations*, as well as through the Corporation Finance Division's *Current Issues and Rulemaking Projects Outline*. Both are available from the SEC's website.

In 1999, the *Telephone Interpretations* addressed the traditional PIPE as follows:

The Division staff was asked about situations in which registration statements are filed for secondary offerings, even though the securities are not yet issued because the primary sale has not yet taken place. When the primary sale is to be made in reliance upon the Section 4(2) exemption, having a registration statement for resale on file before the private

offering takes place would appear to cast doubt upon the validity of the exemption because distribution is clearly contemplated. Also, the registration of a secondary offering under such circumstances may suggest doubt as to whether it is a genuine secondary. The Division staff raises no objection when securities are privately placed with the closing of the private placement contingent on filing or effectiveness of a resale registration statement as long as the purchasers in the private placement are irrevocably bound to purchase the securities subject only to the filing or effectiveness of the registration statement or other conditions outside their control and the purchase price is established at the time of the private placement. The purchase price cannot be contingent on the market price at the time of effectiveness of the registration statement. In addition, when the registration statement is on Form S-3, generally, the shares must be “outstanding” at the time of filing in order to be in compliance with General Instruction I.B.3.

Investor representations. Investors in a traditional PIPE transaction make representations and warranties for the issuer’s benefit. These generally include representations as to each investor regarding that investor’s status as an accredited investor, its opportunity to conduct its own investigation regarding the issuer and its business, an acknowledgment regarding the materials delivered to it by the issuer in connection with the offering, a confidentiality undertaking (discussed below), and an investment representation. The investment representation is essential to a good private placement exemption. Although it is understood that in a traditional PIPE a resale registration statement will be made available at or immediately after the funding or closing of the transaction, the investor is still understood to be at risk during the pendency of the SEC review of the resale registration statement. Hedging during the period between the pricing of the transaction when the purchase agreement is executed and the funding or closing is particularly problematic in light of the investor representations. We discuss these issues below.

Settlement and subsequent transfers. Traditional PIPEs are settled outside the Depository Trust Company system by delivery of physical stock certificates. The transactions also require investors to make payment in advance of receiving their stock certificates (payment versus delivery). This may be problematic for registered investment companies that are limited to delivery versus payment for securities trades. Alternative closing procedures should be made for registered investment companies.

Upon closing of a traditional PIPE, investors receive legended securities. Typically, the resale registration statement is declared effective on the closing date (but subsequent to the actual closing). After the resale

registration statement is declared effective, investors may deliver to the transfer agent a certificate (in contemplation of transferring or otherwise disposing of the securities) acknowledging their prospectus delivery requirement in connection with the shares and making representations concerning future sales. Some issuers prefer to keep a stop transfer order in effect with their transfer agents as a precaution against improper transfers. The issuer's transfer agent then will provide the investors with clean (unlegended) securities. This could happen at closing if investors deliver their certificates to the transfer agent. The shares remain "restricted securities." Future transfers, if made pursuant to the registration statement, still must be made in compliance with the prospectus delivery requirements.

Compared to a private placement with trailing registration rights, a traditional PIPE reduces uncertainty, market risk, and illiquidity. Traditional PIPE investors are not required to close until a resale registration statement is available for the securities purchased in the PIPE transaction. Traditional PIPE investors are able to obtain unlegended shares at, or shortly after, closing, allowing flexibility in disposing of their shares. From a practical perspective, investors in a traditional PIPE do not depend on the transfer agent to deliver clean shares in order to effect subsequent transfers. This eliminates an element of uncertainty.

For most registered investment companies subject to investment limitations, securities purchased in a traditional PIPE count as "public" securities. This broadens the number of potential traditional PIPE investors and also generally justifies better pricing for issuers. Investors in traditional PIPEs include both sector buyers (or long-term holders) and financial buyers (such as hedge funds). Traditional PIPE investors include insurance companies, registered funds, and pension plans. Hedge funds generally favor structured PIPE transactions, which we discuss below in "Nontraditional or Structured PIPEs." Traditional PIPE investors are identified in the "Selling Stockholder" section of the resale registration statements for these transactions.

Using an existing shelf registration statement. We frequently are asked whether issuers with an effective shelf registration statement may use that shelf registration statement in order to complete a traditional PIPE. Usually, the existing shelf registration statement is a primary shelf registration statement covering the sale by the issuer of newly issued securities. For a traditional PIPE, the issuer is required to file a resale registration statement covering the resale by the PIPE purchasers (a selling stockholder shelf registration statement) of the purchased securities. Unless the issuer's existing shelf registration statement covers sales by selling stockholders, the issuer will be required to file a resale registration statement to effect a traditional PIPE.

Engagement letters in a traditional PIPE. In a traditional PIPE, the process is led by the placement agent, rather than by a lead investor. An engagement letter with the issuer outlines the agent's obligations to the issuer, including assisting with preparation of the private placement memorandum and introducing the issuer to potential investors. The letter sets forth the agency fees and the terms and conditions for payment. The placement agent and the issuer may consider carving out of the fee arrangement monies raised from the issuer's "friends and family" or from other investors previously contacted by, or known to, the issuer. A placement agent often negotiates for itself a "tail" affording it the right to receive a fee in respect of future financings, especially other private placements, completed by the issuer during some set period. A placement agent also may negotiate with the issuer a right of first offer or a right of first refusal to participate in future financings or to serve in an advisory capacity.

Generally, a placement agent handling a traditional PIPE receives an agency fee of 4 to 8 percent. The fee depends upon the sector, the proceeds being raised, and other factors. The engagement letter also provides that the issuer will reimburse the agent's fees and expenses. These usually are capped at a maximum of \$150,000—again, varying based on many factors. Usually, expenses include the fees of the placement agent's counsel. Placement agent's counsel assists issuer's counsel with preparation of the private placement memorandum and prepares and negotiates with issuer's counsel the initial draft of the purchase agreement, which is included in the private placement memorandum. Unlike in a straight private placement, in this instance placement agent's counsel coordinates the investors' comments on the purchase agreement and negotiates with issuer's counsel. In some cases, placement agents facilitating traditional PIPEs receive securities, such as warrants, as additional compensation.

Financial arrangements between issuers and placement agents in a traditional PIPE (unlike those in public offerings) are not subject to NASD review. Nevertheless, issuers will disclose the arrangements in their periodic reports or in the resale registration statement, to the extent that the placement agent receives securities as compensation. Any securities issued to the placement agent may "count" for purposes of the various stock exchange limitations on stock issuances requiring shareholder approval.

The engagement letter for a traditional PIPE also provides for closing deliveries, including delivery of a comfort letter and legal opinions from issuer's counsel addressed to the placement agent (or permitting reliance by the placement agent, if addressed to the purchasers). The placement agent conducts its own business and financial due diligence. Investors generally limit their diligence investigation to discussions with management and the company's independent auditors and a review of the private placement

memorandum. Many placement agents take the view that they may be regarded as “underwriters” under the securities laws. As a result, in addition to conducting a thorough due diligence investigation, placement agents request delivery of a comfort letter and legal opinions, which help to form the basis of a due diligence defense. The comfort letter covers the material included in the private placement memorandum, composed principally of the issuer’s publicly filed reports. The legal opinion from issuer’s counsel addresses matters similar to those addressed in opinions given pursuant to underwriting agreements. Most placement agents also request that issuer’s counsel provide a 10b-5 negative assurance as to the private placement memorandum, or, alternatively, the resale registration statement.

The engagement letter also sets forth the issuer’s indemnification obligations. Usually, the engagement letter is the only agreement between the placement agent and the issuer.

Nontraditional or Structured PIPEs

Nontraditional or structured PIPE transactions generally are formatted as private placements with trailing registration rights. This means that once investors execute a definitive purchase agreement, investors fund and the transaction closes. Investors pay for and receive restricted securities bearing a legend. At closing, investors will not have the benefit of an effective resale registration statement for some period, usually sixty to ninety days. Post-closing, the issuer has an obligation to file a resale registration statement and use its best efforts to have it declared effective. Typically, the purchase agreement or a separate registration rights agreement sets deadlines by which the issuer must file and then seek effectiveness of the resale registration statement. Most structured PIPE transactions provide that the issuer will make penalty payments if it fails to meet any registration statement deadline.

The standard terms of a structured PIPE transaction generally include the following:

- A private placement is made to selected accredited investors.
- Investors commit to purchase securities at a fixed price or at a variable/reset price.
- For transactions involving variable/reset pricing, the purchase agreement generally contains specific pricing parameters—which may include a cap on the number of shares that may be issued.
- The purchase agreement generally contains a limitation on blackout periods.
- Promptly following execution of purchase agreements with investors, the transaction funds and closes.
- The issuer files a resale registration statement covering resales from time to time of securities sold in the transaction.

- ❑ The issuer may be obligated to make penalty payments if it fails to meet any registration statement deadline.
- ❑ Investors are named in the resale registration statement as “Selling Stockholders.”
- ❑ The resale registration statement is kept effective until securities may be sold under Rule 144(k).

The closing conditions and covenants in a structured PIPE generally include the following:

- ❑ The purchase agreement contains standard representations and warranties (similar to those contained in an underwriting agreement).
- ❑ For variable/reset deals, the purchase agreement also may contain covenants requiring the future issuance of additional securities at no cost to the investor.
- ❑ The purchase agreement may, depending on the nature of the investors, contain ongoing covenants relating to corporate governance (board representation or observer rights; blocking rights; etc.) or information requirements (regular deliveries of public filings or other information to investors).
- ❑ The placement agent may receive a comfort letter and legal opinions.
- ❑ Before an investor obtains unlegended stock certificates, the investor delivers to the issuer and the transfer agent a certificate regarding compliance with the prospectus delivery requirement.
- ❑ Closing conditions are limited to no occurrence of any material adverse change between execution and closing.

In a structured PIPE transaction, investors have limited liquidity during the pendency of the SEC’s review of the resale registration statement. Once the resale registration statement is effective, investors are able to sell their securities pursuant to the resale registration statement, although they are required to deliver their legended stock certificates and a legal opinion to the transfer agent in advance of a trade. This often results in significant delays as described above.

Structured PIPE transactions usually are variable/reset price transactions. Variable/reset price transactions are especially common in distressed scenarios. In fixed-price transactions, the investor commits to purchase a fixed number of securities at a fixed price, bearing price risk during the period from execution of the purchase agreement through closing. In a variable/reset price transaction, the price risk is shared between the investor and the issuer. An investor might commit to purchase nonconvertible securities at a formula price that varies based on the market price of the issuer’s securities at the time of funding or closing. More

frequently, an investor commits to purchase convertible securities with a conversion ratio that adjusts based on the market price of the issuer's securities at conversion. As discussed in Chapter 2, "The Marketplace: A Statistical Summary," it is important to consider whether a variable/reset price transaction includes price protection. Investors in variable/reset price deals seek downside protection by negotiating for themselves rights that protect the value of their investment in the event of downward fluctuation in the market price of the issuer's common stock. Issuers in variable/reset deals may negotiate a cap or floor to limit their exposure with respect to the maximum number of shares that may be issued as a result of stock price fluctuations or other circumstances triggering antidilution adjustments. Caps or floors also may be necessary in connection with stock exchange regulations.

"Death spiral" or "toxic converts" are "future-priced" securities that represent an extreme example of a variable/reset transaction. A future-priced security is a convertible security in which the conversion price or conversion ratio is tied to a percentage discount to the market price of the underlying common stock at the time of conversion. As a result, the conversion price floats (varies) based on the market price of the underlying common stock. The lower the market price of the common stock at conversion of the convertible security, the greater the number of shares to be issued upon conversion. Death spirals or toxic converts typically reset or adjust only downward to protect the investor, but do not adjust upward to protect the issuer. Because these convertible securities do not have a cap or floor limiting adjustments, the securities may have very dilutive effects on an issuer's stock. Death spirals or toxic converts have attracted the scrutiny of regulators, the financial press, and issuers, along with their boards of directors. Unfortunately for issuers, given the existing confusion about terminology used to describe hybrid financings, this attention has tarnished perceptions about PIPEs.

In a structured PIPE transaction, the purchase price is set through discussions between the placement agent and the issuer, as it is during the course of an underwritten offering. Typically, traditional PIPEs are priced at a modest discount to the closing bid price for the issuer's common stock. However, the pricing of structured PIPE transactions is more complex and usually is based on a formula that relates to the average closing price of the stock over the days preceding pricing. Unlike the traditional PIPE process, in a structured PIPE transaction a lead investor or group becomes more significant in negotiating the offering terms. The investor group may have its own counsel draft the terms of the securities (a certificate of designations for preferred stock or a note).

In addition to negotiating specific carve-outs for representations and

warranties, the placement agent, investors, and issuer typically negotiate the following points:

- whether issuer's counsel will provide a 10b-5 negative assurance
- whether a comfort letter will be required
- whether there will be a limitation on blackout periods
- whether there will be penalty payments
- the time limits for filing and declaration of effectiveness of the resale registration statement
- the conversion ratios or reset provisions and the adjustments to such ratios or provisions, including any caps or floors
- negative covenants

Particularly in distressed scenarios, structured PIPE transactions take on many of the features of a debt financing. Investors negotiate financial covenants, including limitations on liens, limitations on indebtedness, limitations on acquisitions, and other similar restrictions. The securities may bear coupons or have payment-in-kind provisions intended to provide investors with a minimum return. In addition, investors in a structured PIPE transaction may see an incentive, given the terms of the convertible securities, to engage in hedging activities. Their hedging may drive the issuer's stock price down, particularly in advance of conversion periods. Issuers may protect themselves against the negative effects of some hedging activity by including in the purchase agreements limitations on hedging activities; however, these are likely to meet with great resistance from investors.

Structured PIPE transactions raise many of the same regulatory concerns (e.g., stock exchange requirements for shareholder approval) raised in traditional PIPEs or straight private placements. In addition, an issuer should consider whether, in connection with a structured PIPE transaction, the issuer may be required to amend the antitakeover/shareholder rights provisions of its charter documents, as well as whether the issuer may be required to amend a rights plan (poison pill), to raise the percentage limit that would trigger the plan's protective provisions. A structured PIPE transaction also may trigger "change of control" provisions contained in other of the issuer's material agreements.

Issuers also may want to discuss with their placement agent whether announcement of the completion of a structured PIPE transaction may be expected to result in downward pressure on the issuer's stock price. A structured PIPE transaction may, depending upon the characteristics of the offered securities, invite shorting by others (not only the investors) who become aware of the transaction. These transactions also may create a market overhang. Of course, all of these considerations should

be balanced against the issuer's need for additional financing and its other financing alternatives.

Venture-Style PIPE Transactions

Increasingly, venture investors are participating in PIPE transactions—generally, structured as private placements with trailing registration rights, involving fixed-price common stock or fixed-price convertible preferred stock. Venture investors view these venture-style PIPE transactions (or change-of-control PIPEs) as a means of acquiring a significant ownership position in an already public issuer by purchasing equity securities at a discount to market. By purchasing securities in a private placement, venture investors are able to negotiate favorable terms, frequently including board representation, as well as affirmative and negative covenants. Like structured PIPE transactions, venture-style PIPE transactions may require shareholder approval because they often result in (1) the issuance of 20 percent or more of an issuer's outstanding capital stock, (2) the issuance of common stock that will have voting power equal to or in excess of 20 percent of the voting power outstanding, (3) a change of control, and (4) triggering the issuer's rights plan or antitakeover charter provisions.

Private Sales of Secondary Stock

Although the preceding discussion focuses on private placement and PIPE transactions involving primary stock, all the formats described may be used effectively to offer and sell secondary shares. For example, a significant stockholder or a group of stockholders may wish to dispose of their securities. These securities may be restricted securities either because they were acquired in a private placement or because the holders are affiliates. In either case, a PIPE transaction permits the security holders to dispose of their securities in an organized manner, without disrupting the market for the issuer's securities. Instead of dribbling out securities over a period of days or weeks or dumping securities in a block trade (in either case putting downward pressure on the issuer's stock price), the selling security holders will be able to sell their securities in a transaction that is marketed to accredited investors. The transaction is not announced until definitive purchase commitments have been obtained. As a result, the market price of the issuer's stock will not suffer the downward price pressure associated with an overhang.

In a PIPE for a selling security holder, the issuer and the selling security holder engage a placement agent to identify potential purchasers. The engagement letter should be entered into among the placement agent, the issuer, and the selling security holder. The selling security holder requires the issuer's cooperation in order to effect the PIPE transaction. The place-

ment agent works with the issuer to prepare a private placement memorandum containing issuer information. The purchase agreement contains issuer representations and warranties, as well as selling security holder representations. The issuer is required to file a resale registration statement for the resale of the selling security holder's shares by the investors. If there already is an effective resale registration statement covering the resale of the selling security holder's shares, then it is amended to name the new investors in the "Selling Security Holder" section.

Foreign Investors and PIPE Transactions

Foreign investors may participate in PIPE transactions, provided that the offering to each foreign investor is made in compliance with the rules and regulations of his or her jurisdiction. Most European jurisdictions have a "private placement" exemption similar to the Reg D safe harbor.

Integration Issues

Integration is an important area that is not always well understood by practitioners. One reason is that existing regulation is not particularly helpful in resolving fact-specific questions, and relevant SEC no-action letters and *Telephone Interpretations* are sparse. In the absence of very specific authority, practitioners are, in all but the clearest situations, compelled to live with some uncertainty concerning integration questions. The following discussion is an attempt to articulate current thinking and practice in this area.

The five-factor test. In determining whether an offering qualifies for a particular exemption, it is necessary to determine whether it is, in fact, a separate offering, or whether it is part of a larger offering. The SEC has said that five factors, listed previously in this chapter, should be considered in determining whether offerings should be integrated and considered part of the same offering. These factors should be considered when determining:

- whether two or more private offerings should be integrated
- whether a registered public offering should be integrated with an exempt offering
- whether an abandoned private placement may be followed by a public offering without integration
- whether a suspended public offering may be followed by a private placement without integration
- whether any number of other transactions should be integrated

Safe harbors. The five-factor test is a starting point; however, applying the test rarely yields definitive answers. Also, it has never been clear which factor(s) the SEC considers most determinative. In order to elimi-

nate some confusion, the SEC has adopted several safe harbors. These include, but are not limited to: (1) the Reg D six-month safe harbor, discussed previously in this chapter, (2) the Reg D preliminary note providing that Reg S offerings will not be integrated with contemporaneous domestic offerings, (3) the Rule 144A(e) resale exemption, (4) Rule 152 providing that a completed private placement will not be integrated with a subsequently commenced registered offering, and (5) Rule 155 providing issuers with safe harbors when switching from an abandoned private offering to a registered offering, or from an abandoned registered offering to a private placement.

Gun-jumping. Offerings occurring in close proximity to one another also raise other issues, including potential gun-jumping and general solicitation issues. Gun-jumping generally refers to activities occurring prior to the filing or effectiveness of a registration statement in violation of Section 5. These activities, which may include publicity, may condition the market. The SEC has concluded that registering securities offered to investors in a private placement may raise gun-jumping concerns, because investors were solicited and commitments to purchase were received prior to the filing and declaration of effectiveness of a registration statement. Gun-jumping concerns also may arise when a private placement has been abandoned and the issuer then commences a public offering. If the order of events is reversed—for example, where an issuer files a registration statement for a public offering, abandons the public offering, and then commences a private placement—the issuer may find that the private offering may not meet the private placement exemption. The SEC has determined that the mere filing of a registration statement for a specific offering (in contrast to the filing of a shelf registration statement) constitutes a general solicitation. Proposed regulations, if adopted, may offer greater certainty in the future regarding such gun-jumping issues.⁷

Black Box and Squadron Ellenoff no-action letters. The Black Box and Squadron Ellenoff no-action letters expanded the Rule 152 safe harbor. A private placement will be considered “complete” if purchasers enter into definitive purchase commitments and the only conditions to closing are outside of the purchasers’ control. The two no-action letters outlined certain conditions under which an issuer can undertake concurrent private and registered offerings, such as a private placement to QIBs and a handful of other institutional accredited investors, at the same time as a registered offering.

Issues for private placements or hybrid transactions involving convertible securities. Private placements or hybrid transactions involving the issuance of convertible securities or warrants raise related issues. For example, if an issuer relies on a private placement exemption for the

issuance to investors of convertible securities or warrants that are currently convertible or exercisable, the issuer will not be able to register the underlying securities. The SEC views the offering of currently convertible or exercisable securities as an ongoing offering of the underlying securities. Issuers should consider this when structuring a transaction and either provide that the convertible securities or warrants not be convertible or exercisable until some future date or register the convertible securities and the warrants themselves.

Rule 155. Rule 155 of the Securities Act provides issuers with safe harbors for conducting a registered offering following an abandoned private offering or a private offering following an abandoned registered offering. An issuer also may rely on the five-factor test if it chooses not to follow the criteria outlined in Rule 155. In the case of a failed public offering, the issuer must withdraw the registration statement prior to commencing a private placement of the same securities. Nonetheless, the original filing of the registration statement may constitute a general solicitation, rendering the private placement exemption unavailable. Rule 155 requires, in addition to satisfaction of a number of other conditions, a lapse of thirty days between formal abandonment of the public offering and commencement of the private placement. In the case of a failed transaction, the issuer may consider, in addition to the passage of time, structuring a new financing as an issuance of a different security, offering the new security to a different class of investor (for example, only to QIBs, if the abandoned offering had been made only to accredited investors), or conducting the offering pursuant to Reg S.

In light of such uncertainty, an issuer contemplating its alternatives following a failed private placement or a withdrawn public offering may choose to rely on the Rule 155 safe harbors. Under Rule 155(a), an issuer can abandon a private offering exempt from registration under Section 4(2) or 4(6) of the Securities Act, or Rule 506 of Reg D, and follow it soon after with a registered offering if

- no securities were sold in the private offering,
- the issuer terminates all offering activity in the private offering before filing a registration statement,
- any filed prospectus discloses information about the abandoned private offering, or
- the registration statement is not filed until at least thirty days after termination of all private offering activity.

Under Rule 155(b), an issuer may abandon a registered offering and follow it soon after with a private offering if

- no securities were sold in the registered offering,

- ❑ the registration statement is withdrawn,
- ❑ the issuer notifies each offeree in the private offering that the offering is not registered, the securities will be restricted under Rule 144, investors will not be protected under Section 11 of the Securities Act, and the registration statement for the abandoned offering was filed and withdrawn, or
- ❑ the issuer discloses any changes in the issuer's business or financial condition since the filing of the registration statement that are material to the private offering investment decision.

Issues related to PIPE transactions. Other issues may arise if the placement agent or its broker-dealer affiliates purchase securities in a PIPE transaction. Here, the concern is that the SEC presumes that a broker-dealer is acting as an underwriter and, therefore, lacks the investment intent requisite for a private placement. Consequently, the broker-dealer cannot avail itself of a resale registration for the purchased securities. However, securities received by a broker-dealer as compensation (e.g., placement agent warrants) may be registered pursuant to a resale registration statement. Generally, the SEC will require that the broker-dealer's securities be excluded from the PIPE resale registration statement and that the shares be registered separately in a primary registration statement. Alternatively, the SEC may require that the resale registration statement naming the broker-dealer as a selling stockholder be converted into a primary registration statement. In this case, the initial private placement may be considered to have been part of the primary offering.

NASD and Other Regulatory Issues (Shareholder Approval Requirement)

The securities exchange on which an issuer's common stock is quoted may require that an issuer obtain prior shareholder approval in connection with certain private placement or PIPE transactions. For example, prior shareholder approval will be required for a private placement that is completed at a discount, which may result in the issuance of 20 percent or more of the issuer's outstanding capital stock. An issuer should consider not only the effect of completing the proposed transaction, but also, if it has completed other private transactions within the same six-month period, the aggregate effect of such transactions, all of which may be integrated. The New York Stock Exchange, the American Stock Exchange, and Nasdaq all have a similar requirement.

A New York Stock Exchange-listed company must comply with Rule 312.03(c), which requires that an issuer obtain shareholder approval prior to the issuance of common stock or securities convertible into or exercis-

able for common stock, in any transaction or series of related transactions if: (1) 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 (2) 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 securities convertible into or exercisable for common stock. Shareholder approval is not required under this rule if the common stock is sold in a private financing for cash, at a price at least as great as each of the book and market value of the issuer's common stock.

Section 713 of the *Amex Company Guide* requires that an issuer obtain shareholder approval for a transaction involving (1) the sale, issuance, or potential issuance by the company of common stock (or securities convertible into common stock) at a price less than the greater of book or market value, which together with sales by officers, directors, or principal shareholders of the company equals 20 percent or more of presently outstanding common stock; or (2) the sale, issuance, or potential issuance by the company of common stock (or securities convertible into common stock) equal to 20 percent or more of presently outstanding stock for less than the greater of book or market value of the stock.

Rule 4350 of the Nasdaq Marketplace Rules requires that an issuer obtain shareholder approval in connection with a transaction other than a public offering, involving: (1) the sale, issuance, or potential issuance by the issuer, at a price less than the greater of book or market value, of common stock (or securities convertible into or exercisable for common stock) that, together with sales by officers, directors, or substantial shareholders of the company, equals 20 percent or more of common stock or 20 percent or more of the voting power outstanding before the issuance; or (2) the sale, issuance, or potential issuance by the company, for less than the greater of book or market value, of common stock (or securities convertible into or exercisable for common stock) equal to 20 percent or more of the common stock or 20 percent or more of the voting power outstanding before the issuance.

The securities exchanges also require shareholder approval

- for an issuance that may exceed 20 percent of the common stock,
- when 20 percent or more of the voting power is outstanding before the issuance if the issuance is related to an acquisition, or
- if the issuance will result in a change of control, which is defined as a transaction that results in an investor or group of affiliated investors obtaining a 20 percent interest in the issuer on a post-transaction basis or the right to acquire such an interest.

Structuring Alternatives

Determining whether a proposed transaction requires shareholder approval under these exchange regulations may be difficult. If the proposed transaction involves the issuance of stock at a fixed price, it is easy to determine whether the transaction will result in the issuance of stock equaling 20 percent or more of the outstanding stock. However, it may be more difficult to ascertain whether an issuance of convertible securities, especially if the convertible securities have an adjustable conversion ratio, will violate the exchange prohibitions. The exchanges require that an issuer obtain shareholder approval if an issuance of convertible securities may result in the issuance of stock equaling 20 percent or more of the outstanding stock and suggest that, in the case of convertible securities, the issuer establish a maximum number of conversion shares issuable prior to obtaining shareholder approval. If a proposed transaction includes common stock and warrants, the exchange generally will consider whether the 20 percent threshold is exceeded by the issuance of the common stock alone, or only when aggregated with the issuance of the warrants. If the issuance of the common stock alone is less than the threshold, but the threshold is exceeded upon issuance of the warrants, the exchange will blend the prices of the common stock and the warrants (if immediately exercisable) in order to test whether the combined price represents a discount to the greater of book or market value.

Another difficulty arises in instances where the issuer has completed several private financings within a short period. If the financings were completed within a six-month period, the exchange rules presume that they should be integrated and considered part of a continuing offering for purposes of the shareholder approval provisions. The issuer may refute the presumption that the financings should be integrated by distinguishing among the financings using the SEC's five-factor integration test. If an issuer completed a private financing recently and is considering commencing another financing transaction, it should consider the integration test in structuring its second financing. The second financing may involve a different security, a different use of proceeds, and a different class of investors (for example, an offering made to QIBs only, instead of to accredited investors). In any event, the issuer will want to discuss with the exchange the details of the proposed financing and obtain clearance before proceeding.

The exchange rules also aggregate private placements of secondary shares held by directors, officers, or substantial stockholders with private placements of primary shares that occur contemporaneously.

Disclosure Issues Arising in Connection With Private Placements, PIPEs, and Other Hybrids

Since the first edition of this book was published in 2003, issuers, investment banks, investors, and their advisers have focused particular attention on disclosure issues arising in connection with private placements, PIPEs, and other hybrid transactions. The SEC also shares interest in this topic; it has been engaged in a widely reported investigation relating to hedge funds, their short trading activities, and their participation in PIPE transactions. It is against this backdrop that we offer the following discussion of current market practice and actions we believe may prove useful in meeting evolving disclosure standards.

An issuer commencing a private financing may consider requesting that potential purchasers contacted by the placement agent execute a confidentiality agreement. Potential investors evaluating a private placement for a private company may be accustomed to executing confidentiality agreements. Indeed, these potential investors likely will receive a private placement memorandum containing projections and other forward-looking information. The placement agent, the issuer, and the potential investors may devote several days to negotiating confidentiality agreements.

By contrast, potential investors contacted regarding their possible participation in a PIPE or other hybrid transaction for a public issuer will not expect to be asked to execute a confidentiality agreement. Usually, an issuer has prepared a private placement memorandum containing only its publicly filed documents and a brief description of the proposed transaction. This private placement memorandum will not contain information concerning the issuer that has not already been disclosed publicly. Issuers do not include projections in a private placement memorandum. An issuer may meet potential investors for one-on-one or road show meetings; however, the issuer will limit its presentation to information that is publicly available. As a result, the only information that a potential investor receives that is otherwise not known to the general public is that the issuer is contemplating a financing. Consequently, potential investors resist signing a confidentiality agreement. Furthermore, negotiating a confidentiality agreement is time-consuming. Given the compressed PIPE timetable, it may be unrealistic to devote several days of a one- to two-week process to negotiating confidentiality agreements.

Nonetheless, the issuer and the placement agent may take a number of other precautions. Recently, a number of investment banks have asked that their institutional investor clients execute omnibus confidentiality undertakings in which the clients acknowledge that, from time to time, they may receive from the investment bank nonpublic information in connection with evaluating investments in private placements, PIPEs, and other

hybrid transactions and that they understand and will fulfill their responsibilities relating to the handling of such information. We suggest that the placement agent also use an “investor script” to prequalify potential investors in each transaction. The script alerts investors that they will receive confidential, nonpublic information before learning the issuer’s name and requires that the placement agent receive an oral confidentiality agreement from the potential investor prior to disclosing the issuer’s name. The private placement memorandum also contains important legends alerting recipients that the document contains information, which should not be shared, about a possible transaction that has not been publicly disclosed. The placement agent and the issuer should control carefully the distribution of the private placement memorandum by keeping track of the number of copies that have been distributed and to whom copies have been sent. It is preferable to send actual paper copies of the private placement memorandum instead of electronic versions through e-mail, which are easy to forward. If it is necessary to send copies through e-mail, the placement agent and the issuer should take precautions, such as sending a pdf read-only version accompanied by a transmittal message alerting the recipient to its obligations in respect of the information. The placement agent should keep track of all sent e-mails. The issuer may request that copies of the private placement memorandum be returned to it or to the placement agent or destroyed upon consummation or abandonment of the transaction.

Often in connection with structured PIPE transactions, the issuer and the placement agent do not prepare a private placement memorandum and, instead, use only a detailed term sheet. A term sheet should (1) be properly legended to alert recipients that the term sheet is not binding, (2) suggest indicative terms only that remain subject to negotiation, and (3) identify the terms of a potential transaction, the existence of which has not been publicly disclosed and that, as a result, may constitute material nonpublic information.

Venture funds considering an investment structured as a PIPE may be interested in conducting their own, more in-depth due diligence investigation. These investors may suggest entering into a confidentiality agreement in order to obtain access to more detailed information, including financial projections, from the issuer.

Regulation FD. Regulation Fair Disclosure, or Reg FD, introduces an additional cautionary element to the marketing process. The issuer is sharing with potential investors information (regarding a possible financing transaction) that is not known to the market generally. Before the placement agent begins discussing the details of the issuer and the possible financing transaction, the placement agent should use an investor script.

The investor script is consistent with SEC guidelines, as well as with internal compliance guidelines used by investment banks and other large financial institutions.⁸ The investor script should alert the investor that the placement agent is contacting the investor regarding a possible private transaction and should require that the investor agree orally to keep the information confidential and acknowledge that the investor understands how to handle confidential information under the securities laws.

An issuer is owed a duty of confidence from its agents, such as its placement agent, lawyers, accountants, and other similar participants in the financing process.⁹ Generally, an issuer will not share with potential investors information that has not already been included in its Exchange Act reports. Although the issuer is not sharing material nonpublic information regarding its business with potential investors, the issuer is sharing its plans concerning a potential financing. The fact that the issuer is contemplating a financing transaction may itself constitute material nonpublic information.

The issuer should ensure that, before the placement agent reveals the issuer's name, the placement agent obtains oral agreements from each potential purchaser it contacts. Reg FD requires that the agreement to maintain confidentiality must be express and provides that an oral agreement suffices. However, we recommend that this express oral agreement be documented subsequently through a written acknowledgment by the investor in the purchase agreement that the oral agreement was entered into at the time of the "offer," along with a covenant that the purchaser will continue to keep the information confidential until the issuer publicly discloses details concerning the financing. Often, investors request that the issuer file a Current Report on Form 8-K disclosing the financing within a certain time (usually twenty-four to forty-eight hours) following execution of definitive purchase commitments. Once a press release is issued, the investors and other potential investors contacted by the placement agent are released from their confidentiality undertakings and accompanying trading restrictions.

From a practical perspective, a private financing for a public company is accomplished most effectively when the "marketing" process is focused and compressed. The placement agent should consider limiting the marketing process to a few days or a few weeks in order to limit the possible effect of having information about a possible transaction leak and affect the issuer's stock price. In addition, the placement agent should be guided by its "know-your-customer" policies when approaching potential PIPE investors.

Rule 135c safe harbor. The SEC has adopted a number of rules identifying and excluding certain communications, as well as certain activities, from being considered an "offer" or from being considered a part

of a “prospectus.” Rule 135c provides a safe harbor for a reporting issuer to make announcements of offerings that are not registered or required to be registered under the Securities Act. An issuer must file the announcement on a Form 8-K or 6-K (for foreign issuers). In order for the issuer to benefit from the safe harbor, the Rule 135c press release must include only (1) the issuer’s name, (2) the title, amount, and basic terms of the offered securities, (3) the amount of the offering that consists of selling security holder shares, (4) a brief description of the manner of the offering and the proposed use of proceeds, without naming the placement agent, and (5) a Securities Act legend. An issuer may consider making such a press release during a PIPE transaction. However, most issuers choose to wait and announce the transaction when definitive purchase agreements have been executed. In fact, issuers often cite that one of the most significant benefits associated with PIPE transactions is that such transactions may be commenced without public disclosure.

Other announcements during a private placement. As we discussed above, Reg D prohibits general solicitation and general advertising including, but not limited to, the following: “(1) any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and (2) any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.” Through a series of no-action letters and staff guidance, the SEC has identified other factors relevant to determining whether an issuer, or persons acting on the issuer’s behalf, have made a general solicitation or engaged in general advertising. The staff has said that it would, in the context of evaluating whether there was a general solicitation, consider whether there was a preexisting relationship between the issuer and the potential investor or, in instances where the issuer uses a placement agent, whether there was a preexisting relationship between the agent and the potential investor that permitted the agent to ascertain, in advance of making a specific solicitation, that the potential investor met the required qualifications for participating in a private placement of the kind being offered to it. The staff has examined closely communications made by third parties, especially by news services, relating to ongoing private placements. In particular, the staff considers whether the issuer may have authorized or consented to having the third party publicize the information.

An issuer commencing a private placement should exercise caution and examine its communications during the offering period, including materials posted on its own Internet site, as well as on third-party sites, advertisements of its products and services, announcements regarding new products or results of clinical trials, and announcements regarding strategic alliances, mergers, or acquisitions.

An issuer contemplating a possible financing also should discuss with its counsel significant announcements or presentations. For example, issuers often are asked to participate in, or present at, investment bank–sponsored conferences or to participate with an investment bank in an informal road show, sometimes referred to as a nondeal road show. An issuer that would like to commence a financing transaction in close proximity to such a conference or nondeal road show should be especially careful about the information it shares at these presentations.

Research coverage and research reports. Regulators and the financial press have focused great attention on issues relating to research analyst conflicts and research coverage. The SEC has adopted regulations relating to research analyst conflicts of interest.¹⁰ Similarly, the national securities exchanges have adopted rules relating to research analyst conflicts of interest and certification by research analysts of their research reports.¹¹ This discussion will not address such regulations.

Undoubtedly, research analysts and research reports influence market behavior. In connection with financing transactions, research reports may be considered “offers” under Section 2(3) of the Securities Act. Issuance of a research report in advance of a public offering may constitute gun-jumping and, as a result, violate Section 5 of the Securities Act; or a report may be viewed as part of a “prospectus.” A research report also may violate Regulation M (see below). In order to provide some certainty, the SEC created safe harbors, Rules 137, 138, and 139, that apply to research reports. By their terms, these research safe harbors apply to the distribution of research reports in advance of, or during, a public offering. Staff interpretations of these safe harbors appear to extend the application of the safe harbors to Rule 144A and Reg S offerings; however, these safe harbors do not extend to private placements. Nonetheless, many placement agents consider the guidelines provided by these rules helpful.

More complex issues arise if the placement agent does not already provide research coverage for the issuer and is considering picking up research coverage, or if the placement agent is considering changing the issuer’s rating. The placement agent should consult with its compliance department and its counsel.

Compliance by the Placement Agent With Regulation M

Regulation M, or Reg M, applies to private placements that involve a “distribution.” Under Reg M, a distribution means “an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.” If the private placement satisfies the “magnitude” and “special selling

efforts and selling methods” criteria, then it is considered a “distribution” for Reg M purposes. Most private placements with trailing registration rights, PIPEs, and other hybrids are likely to be distributions. The issuer engages a broker-dealer to act as its agent. The issuer and the agent prepare special selling materials (the private placement memorandum) and engage in special selling efforts by arranging investor meetings and presentations. During a distribution, the placement agent must comply with the Reg M “restricted period.” Depending on the average daily trading volume of the issuer’s listed security, the relevant restricted period during which the placement agent must refrain from making a market in the issuer’s securities is either one or five days prior to the determination of the offering price. The relevant Reg M period for an agent participating in a PIPE transaction is either one or five days prior to the pricing, rather than prior to the funding or closing of the PIPE. The placement agent should consult with its compliance department and its counsel.

Investment Representations and Hedging

As discussed above, to ensure that the securities sold in the offering come to rest with the immediate purchasers, issuers request that investors make investment representations, to the effect that they are purchasing the securities with an intent to hold and not with a view to a distribution. Investors that violate the investment representation by disposing of the securities prematurely may be deemed to be statutory underwriters and, as a result, may be unable to rely on the Section 4(1) resale exemption.

There are obvious tensions in some of the hybrid transactions we have discussed above. Issuers with capital needs may choose a private placement because it often reduces the time and expense associated with a financing. Investors seek the liquidity associated with a registered offering. Because the divide between straight private placements and public offerings has narrowed due to the proliferation of hybrid transactions, investment representations in private placement subscription documents must be reconciled with the almost immediate availability of a resale registration statement. The SEC has emphasized that investors in a private placement or in a PIPE made in reliance on the Section 4(2) exemption or in reliance on Rule 152 must bear the risk of holding the restricted securities they committed to purchase before a resale registration statement is filed. The purchase price cannot be contingent on the market price of the securities at the time of effectiveness of the registration statement. In the case of convertible securities with an adjustable conversion ratio, the formula used to calculate the conversion ratio must be agreed upon prior to the filing of the registration statement.

Investors participating in private placement and hybrid transactions, especially in structured PIPE transactions, may engage in hedging trans-

actions that raise concerns about the integrity of their investment representations. Issuers have attempted to address these concerns by bolstering the investment representations, taking a number of different approaches: prohibiting entirely any hedging activities, direct or indirect; obtaining representations from the investors that the investors do not have a “net short position” in the issuer’s securities when the purchase agreement is executed; specifically proscribing certain hedging transactions in advance of conversion periods; or prohibiting investors from trading in the securities of the issuer during particular periods.

Investors contacted by a placement agent concerning a private transaction have received material nonpublic information, which they will be asked to keep confidential. Trading, including entering into hedging transactions in the issuer’s securities, based on nonpublic information would violate the securities laws. The SEC’s investigation into PIPE transactions appears to focus on trading (including shorting) by hedge funds based on nonpublic information.

Once the private placement transaction has been announced, either through a press release or in a Current Report on Form 8-K, investors no longer have any material nonpublic information (assuming that they have no other special knowledge). Subject to the contractual prohibitions contained in the purchase agreement, including the investment representation, investors may enter into hedging transactions; however, there is little or no SEC guidance concerning the transactions that would be considered appropriate and that would not vitiate the investment representation. In its *Telephone Interpretations*, the SEC staff considered the following:

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 SEC concluded that the short sale could not be made before the registration statement becomes effective because the shares that are the subject of the short sale are deemed to be sold at the time such sale is made. There would be a Section 5 violation if the shares were effectively sold prior to the effective date of the registration statement. Along the same lines, the SEC in its analysis of certain equity line arrangements emphasized that, if the purchaser is not at market risk prior to effectiveness of the registration statement, the purchaser should be considered an “underwriter.”

Investors and their counsel may find a rationale for certain kinds of hedging activity following execution of a purchase agreement and public

announcement of the financing if investors cover short sales by buying shares in the market rather than using shares registered pursuant to the registration statement to cover short sales. In mid-2002, the SEC announced its intention to clarify many of its positions on hedging.

Regulation SHO

In July 2004, the SEC promulgated Regulation SHO (Reg SHO),¹² which imposes new restrictions on certain short selling activities, particularly in connection with shelf takedowns. Among other things, Reg SHO creates a uniform rule requiring that, prior to effecting a short sale in an equity security, a broker-dealer “locate” securities available for borrowing to cover such short sales. Reg SHO also establishes additional delivery obligations for broker-dealers with respect to certain securities that have experienced settlement failures to deliver. More or less concurrently, the SEC adopted amendments to Rule 105 of Reg M, which prohibits covering short sales effected immediately prior to the pricing of an offering (during the applicable Reg M restricted period) with securities received in the offering. Reg SHO eliminates the prior exception in Rule 105 for shelf offerings.

These regulations are intended to curb abuses related to naked short sales and manipulative practices. Although the regulations may not apply strictly to PIPEs, they are applicable to many hybrid offerings effected as shelf takedowns, and evidence the SEC’s interest in curtailing abuses related to short trading activities.

Equity Lines of Credit

In an equity line of credit arrangement, the issuer enters into an agency agreement with an investor pursuant to which the issuer has the right, during the term of the arrangement, subject to certain terms and conditions, to put its securities to the investor. Some equity lines of credit are completed using a shelf registration statement and others are completed as continuous private placements with a continuing obligation on the issuer’s part to register the resale of the securities sold to the investor. (For a more extensive discussion of equity lines, please see Chapter 7, “Registered PIPEs: Registered Direct Transactions.”)

An equity line of credit may involve the formula-pricing associated with death spiral financings. Under many equity lines, the price paid by the investor for the issuer’s securities upon receipt of a drawdown notice (a put to the investor) is calculated based on a discount to the then-market price of the issuer’s common stock (or an average of the market prices of the issuer’s common stock over the ten or twenty days immediately preceding the drawdown date). As a result, an equity line that involves formula-pricing may have a dilutive effect.

Future-priced equity lines also invite shorting both by the investors participating in the transaction and by others who become aware of the existence of the equity line. The mere existence of the equity line likely will create a market overhang, exerting downward pressure on the market price of the issuer's securities over the life of the line.

In a number of *Telephone Interpretations*, the SEC addressed many of the problematic practices associated with these kinds of equity lines. In particular, the SEC has acknowledged that the delayed nature of the puts and the lack of market risk resulting from the formula pricing associated with equity lines of credit differentiate these from PIPE financings and result in the SEC's conclusion that equity lines should more properly be classified as indirect primary offerings. Other kinds of equity lines, such as those completed as takedowns of primary shares from an issuer's effective shelf registration statement, where the put price is based on the market price of the issuer's common stock at the time of the put exercise, should comply with the at-the-market offering rules of Rule 415.

Shelf Registration Statements

An issuer considering its range of financing alternatives should include filing a kitchen sink shelf registration statement or an equity-only shelf registration statement. Having a shelf registration statement available will permit the issuer to have a broader array of financing alternatives and may permit the issuer to finance opportunistically, as further discussed in Chapter 7.

Requirements for Form S-3. In order to file a shelf registration statement using a registration statement on Form S-3, an issuer must be eligible to use Form S-3 for primary offerings. The issuer must meet the following criteria:

- ❑ The issuer must be organized under the laws of the United States and have its principal business operations in the United States.
- ❑ The issuer must have a class of securities registered pursuant to Section 12(b) of the Exchange Act or a class of securities registered pursuant to Section 12(g) of the Exchange Act or must be required to file reports pursuant to Section 15(d) of the Exchange Act.
- ❑ The registrant must have been subject to the requirements of Section 12 or 15(d) of the Exchange Act and have filed all the material required to be filed pursuant to Sections 13, 14, or 15(d) for a period of at least twelve calendar months immediately preceding the filing of the registration statement and, if the registrant has used (during the twelve calendar months and any portion of a month preceding the filing of the registration statement) Rule 12b-25(b) under the Exchange Act with respect to a report or to a portion of a report, that report or portion thereof that has

actually been filed within the period of time required by the rule.

❑ Neither the registrant nor any of its consolidated or unconsolidated subsidiaries have, since the end of the last fiscal year for which certified financial statements of the registrant and its consolidated subsidiaries were included in a report filed pursuant to Section 13(a) or 15(d) of the Exchange Act: (a) failed to pay any dividend or sinking fund installment on preferred stock; or (b) defaulted (i) on any installment or installments on indebtedness for borrowed money, or (ii) on any rental on one or more long-term leases, which defaults in the aggregate are material to the financial position of the registrant and its consolidated and unconsolidated subsidiaries, taken as a whole.

❑ The aggregate market value of the issuer's voting and nonvoting common equity held by nonaffiliates of the issuer is \$75 million or more.

If the issuer meets the Form S-3 criteria for primary offerings, then it may register the sale of either a fixed number of securities or a fixed dollar amount of securities. The securities may include common stock, preferred stock, warrants, debt (convertible or nonconvertible), or equity-linked securities. The securities may be sold at any time (typically during a two-year period).

The base prospectus. A base prospectus forming a part of the registration statement describes the generic kinds of securities that the issuer might offer from time to time pursuant to the registration statement. The "Plan of Distribution" section of the base prospectus describes all of the various distribution methodologies that the issuer may employ in connection with sales pursuant to, or takedowns off of, the shelf registration statement. These methodologies might include firm commitment offerings, agency offerings, block trades, at-the-market offerings (which are subject to certain additional conditions), a continuous offering program (such as a medium-term note program), or an equity line of credit. The details of a specific takedown are described by the issuer in a prospectus supplement, which supplements the base prospectus. Individual prospectus supplements generally are not subject to SEC review. As a result, an issuer with an effective shelf registration statement is not dependent on the SEC to review a prospectus supplement.

Registered Direct Offerings

An issuer with an effective shelf registration statement may consider a registered direct offering as another of its financing alternatives. In a registered direct offering, an investment bank is engaged to act as a placement agent and commits to introduce the issuer to potential investors. The offering may be completed using a single-purpose registration statement if the is-

suer does not have an effective shelf registration statement. Alternatively, if the issuer already has a universal or equity shelf registration statement on file with the SEC, a registered direct offering may be a means of structuring a shelf takedown. In either case, the prospectus (or prospectus supplement, for a shelf takedown) describes on the cover page and in the “Plan of Distribution” section an offering made on an agency basis principally to institutional investors. The “Plan of Distribution” describes that the closing process involves settling through DTC on a regular T + 3 or T + 4 basis through an escrow account.

Issuers without effective universal shelf registrations. If an issuer does not have a universal shelf registration statement on file, it may file a registration statement with the SEC on the appropriate form. The registration statement describes the offering process. Because the offering process involves a more limited distribution methodology when compared to an underwritten follow-on offering, the issuer’s stock generally is subject to a reduced risk of shorting upon filing of the registration statement. There is less incentive for hedge funds to short stock in anticipation of receiving deal stock because the distribution is limited and there is no assurance that they actually will be allocated any deal stock. Because registered direct offerings are targeted to institutional investors, these offerings may be less likely to be subject to SEC review. A closing can occur as soon as the single-purpose registration statement is declared effective.

An issuer with an effective universal or equity shelf registration is even better situated to benefit from a registered direct offering. A placement agent may conduct a shelf takedown as a registered direct offering overnight or over the course of a few days. Depending on marketing needs, the placement agent and the issuer may choose to produce a preliminary prospectus supplement. Alternatively, given the availability of an effective shelf registration statement, the placement agent may choose to market the transaction without a preliminary prospectus supplement. These considerations bear a striking similarity to those for a fixed-price traditional PIPE transaction.

The increased popularity of universal shelf registration statements makes this offering methodology even more attractive at a time when the public markets open and close with little predictability or warning.

Registered direct offerings are discussed in greater detail in Chapter 7.

Bought Deals

If an issuer has an effective shelf registration statement, it also may consider a bought deal as a financing alternative. Bought deals, or “overnighters,” are firm commitment transactions wherein the issuer requests that one or more investment banks submit a “bid” or quote an underwriting spread for

a firm commitment offering of a specified number of shares of the issuer's stock to be sold immediately or within a one- or two-day period. The issuer chooses an investment bank and the investment bank underwrites the offering without the benefit of advance marketing. This may be an attractive option for an issuer in need of immediate cash, or for one that fears its stock price will be subjected to shorting if a public offering is announced. Issuers also like the fact that underwriting spreads for bought deals tend to be lower than those for traditional firm commitment underwritings. Although this is attractive, issuers also should consider whether the underwriter in a bought deal will be able to place the securities with holders. Given that the transaction takes place over a short period of time, it is often the case that securities are not placed with holders, creating volatility in the stock.

Conclusion

The legal and regulatory considerations relating to private, PIPE, and hybrid transactions often are the determining factor in choosing a particular financing structure. This is somewhat unusual insofar as we are all accustomed to selecting a transaction structure and, thereafter, focusing on how to satisfy applicable legal and regulatory requirements. This difference makes it essential for issuers, financial intermediaries, and their advisers to understand these considerations in sufficient depth to permit them to choose the optimal transaction structure at inception, rather than after a painful period of trial and error.

Chapter Notes

1. Rules 504 and 505 of Regulation D were promulgated under Section 3(b) of the Securities Act; Rule 506 is based on Section 4(2) of the Securities Act.
2. Section 4(1) exempts "transactions by any person other than an issuer, underwriter or dealer."
3. Accredited investors are not counted as "purchasers" for purposes of counting purchasers under Reg D.
4. Although the term "income" is not defined under Reg D, the SEC has approved the following method of computing income for purposes of Reg D: individual adjusted gross income increased by (i) any deduction for long-term capital gains, (ii) any deduction for depletion, (iii) any exclusion for interest, and (iv) any losses of a partnership allocated to the individual limited partner.
5. For a full discussion of Rule 144 and its application, see J. William Hicks, *Resales of Restricted Securities* (2002, West Group).

6. Rule 144 defines an affiliate of an issuer as a “person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, such an issuer.” Determining whether a person is an affiliate depends on the facts and circumstances of each situation and should be made in consultation with counsel for the issuer.
7. The SEC has proposed regulations designed to modernize the registration, communications, and offering processes under the Securities Act. See SEC Release Nos. 33-8501 and 34-50624.
8. Investment banks and other large financial institutions have their own “Chinese wall” or similar procedures. The fact that the issuer, through its placement agent, shares information with one part of an investment bank, for example, does not mean that the issuer will be deemed to have shared the confidential information with other parts of the investment bank. The same usually is true for large fund complexes that are frequent PIPE buyers.
9. Rule 100(b)(2) of Regulation FD sets out four exclusions from coverage. The first is for communications made to a person who owes the issuer a duty of trust or confidence—i.e., a “temporary insider”—such as an attorney, investment banker, or accountant. The second exclusion is for communications made to any person who expressly agrees to maintain the information in confidence.
10. See SEC Release No. 34-48252 (July 29, 2003).
11. See SEC Release No. 34-45908 (May 10, 2002); NYSE Rules 344, 351, and 472; and NASD Rule 2711 relating to research analyst conflict issues.
12. See SEC Release No. 34-50103.

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