SEC FORMALIZES ITS POSITION ON PIPE TRANSACTIONS

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Private investment in public equity offerings, labeled “PIPEs” by market participants, have become a permanent alternative for raising equity capital by public companies in need of financing. Pursuant to informal guidance issued by the Staff of the Securities and Exchange Commission (“SEC”) in the mid 1990s, PIPEs have been treated as completed private placements not subject to integration with subsequent registered secondary offerings by selling securityholders. Under this guidance, PIPE investors have been able to have the shares issued in (or the shares underlying convertible securities issued in) the PIPE transaction registered for public resale into the trading market concurrently with or soon after the closing of the PIPE transaction. Recently, as described below, the treatment of PIPE investors in registered offerings as just selling securityholders, as opposed to statutory underwriters, has been called into question in certain circumstances.

In a series of recent public statements, the Staff of the SEC’s Division of Corporation Finance has provided informal guidance as to the circumstances, under which it would view a registered offering of securities on behalf of PIPE investors as a primary offering on behalf of the issuer. In these circumstances the offerings would no longer be viewed as permissible delayed or continuous secondary offerings on behalf of selling securityholders under Rule 415(a)(1)(i) of the Securities Act of 1933 (the “Securities Act”), which permits delayed or continuous offerings on behalf of unaffiliated selling securityholders. In particular, the Staff indicated that, if the number of shares proposed to be registered on behalf of PIPE investors constitutes more than one-third of the issuer’s non-affiliate public float (i.e., one-third of the outstanding shares held by non-affiliates) immediately prior to the PIPE transaction, the Staff will presumptively view the proposed registered offering of shares for resale by the PIPE investors as an indirect primary offering made on behalf of the issuer, in which case the PIPE investors would be viewed as effectively acting as statutory underwriters with respect to the resale of their shares to the public.

BACKGROUND

PIPE transactions have two components. The first component involves the original issuance of the securities – i.e., the private placement of securities by a public company to one or more accredited investors in reliance on the statutory private placement exemption provided by Section 4(2) of the Securities Act and/or private offering exemption provided by Regulation D under the Securities Act. The securities sold in PIPEs may include common stock, straight or convertible preferred stock, convertible debt or a combination of these securities, as well as warrants that are issued to investors as a “sweetener.” Since they are privately placed to the PIPE investors, such securities are considered “restricted securities” within the meaning of the rules under the Securities Act.

Because the PIPE investors require resale liquidity, the second component involves the filing of a registration statement by the issuer to register with the SEC the reoffer and resale of the shares issued in the PIPE by the investors as named selling securityholders on a delayed or continuous basis in one or more transactions at varying prices (i.e., variable priced). Although the PIPE can be structured so that an effective registration statement is a condition to the closing of the PIPE, most PIPEs today provide for the filing of a registration statement with the SEC within some number of days after the PIPE is closed. Once the SEC declares the registration statement effective, the PIPE investors are then generally able to freely resell their shares in the trading market.
PIPEs offer a number of advantages over other financing alternatives. In particular, PIPEs allow issuers to raise capital much more quickly than an SEC registered primary public offering by the issuer. Moreover, PIPEs may be completed on a confidential basis. With registered public offerings, issuers are often forced to publicly announce their intent to sell shares by filing a registration statement with the SEC in advance of pricing and confirming purchase orders from investors. In many cases, issuers are not shelf registration eligible, or if shelf registration eligible, other factors are present that would prevent a shelf takedown either as an overnight bought deal or a confidentially marketed direct public offering. The filing of a registration statement or a Red Herring prospectus filed under a shelf registration statement for a marketed offering has a tendency to create “overhang,” where the market perceives the pending issue as potentially dilutive, which can exert downward pressure on an issuer’s stock price and ultimately reduce the price at which shares may be sold by the issuer in the offering. On the other hand, most PIPEs do not require any public disclosure by issuers until their purchase agreement with investors has been executed and the price at which the securities are sold has been determined.

Historically, the Staff has permitted issuers to register a significant number of shares issued in PIPE transactions for reoffer and resale by PIPE investors under a “resale shelf” registration statement as permitted by Rule 415(a)(1)(i) under the Securities Act. Rule 415(a)(1)(i) allows issuers to register the reoffer and resale of the shares issued in the PIPE on behalf of investors, who are able resell them over time on a delayed or continuous basis in one or more transactions at varying prices, rather than at a fixed price. In many cases, the Staff has accepted for filing resale shelf registration statements that have included shares representing more than 75% (and in some cases, more than 100%) of the issuer’s non-affiliate public float.

**THE STAFF’S “NEW” POSITION**

**The New One-Third Test**

Beginning in 2006, the Staff began cracking down on issuers attempting to use Rule 415(a)(1)(i) to register the shares issued in large PIPE transactions for immediate resale by investors. Specifically, through a series of public presentations and interviews, members of the Staff announced the following position: if an issuer seeks to register shares issued in a PIPE that constitutes one-third or more of its shares held by non-affiliates as of immediately prior to the PIPE, the registration will be presumed to be a primary offering on behalf of the issuer, and the PIPE investors whose shares are being registered will be deemed underwriters of the offering. That is, the SEC will presume that the investors are effectively acting as a conduit for issuers to sell shares directly to the investing public.

The Staff appears to be particularly concerned that issuers may be attempting to disguise offerings made on their behalf as offerings made on behalf of PIPE investors in order to obtain the benefits of shelf registration, including the ability to effect an “at the market” offering to the public on a delayed or continuous basis using a Form S-3 shelf registration statement that the issuer might not otherwise be eligible to use. Although the Staff announced that it does not intend to release formal guidance on this issue, it has informally articulated several points that issuers must address in PIPE registration statements. Issuers must address

- how long the investors have held the shares, the circumstances under which the investors received the shares, the investors’ relationships to the issuer, the amount of shares involved in the registration, whether the investors are in the business of underwriting securities and whether, under all the circumstances, it appears that the investors are acting as a conduit for the issuer.\(^1\)
- the number of investors included in the registration and the percentage of the offering being sold by each investor;
- the identities of the natural persons with voting or investment power over the securities registered on behalf of the investors;
- the relationships among the investors;
- any payments the issuer has made, or will make, to the investors, their affiliates and/or the placement agent for the PIPE;
- the net proceeds received by the issuer from the PIPE after taking into account all payments and expenses (i.e., how much the issuer will actually receive from the sale of the securities);
- how the issuer determined the number of securities to sell to investors in the PIPE;

\(^1\) These factors are set forth in Question D. 29 of the Staff’s Manual of Publicly Available Telephone Interpretations.
• if the issuer sold convertible securities, the issuer’s good faith estimate of the actual number of shares that will be issued to the investors upon conversion of those securities (i.e., the maximum dilutive effect of these securities);
• if the issuer sold convertible debt, the issuer’s ability or intention to repay the debt;
• if known to the issuer, the current short positions held by any of the investors; and
• whether the issuer had recently completed one or more financings with the same group of investors (i.e., whether the issuer is disguising one large PIPE as a series of smaller ones).

According to the Staff, these points are designed to ensure that issuers provide full and accurate disclosure about the underlying terms of the PIPE so that retail and other investors looking to purchase the registered shares that were issued in the PIPE are aware of the dilution that may result from these transactions. The Staff also noted that it will give particular attention to “death spiral” or “toxic convertible” PIPEs. These typically involve the sale of convertible securities with adjustable conversion prices tied to the price of the issuer’s common stock. If the price of the issuer’s underlying common stock drops, holders of the convertible securities can convert their securities into a greater number of shares, which may cause a further decline in the issuer’s stock price and result in additional dilution.

Not a Bright-Line Threshold

The Staff has long indicated that a purported secondary offering on behalf of selling securityholders may be a deemed a primary offering on behalf of the issuer depending on the facts and circumstances of the offering. However, this is first time the Staff has formally announced an actual test for evaluating these registration statement issues. Although it has been careful to note that this threshold is not a bright-line test, the Staff believes that the one-third threshold will serve as a useful benchmark for issuers and investors contemplating PIPE transactions. As a result, depending on the other facts and circumstances of the offering, issuers may be required to address each of these disclosure points even when the proposed resale registration statement covers less than one-third of the shares held by the non-affiliates prior to the PIPE transaction.

INITIAL RESPONSE BY ISSUERS AND INVESTORS

The Staff’s new guidance began taking shape through a series of comment letters delivered to issuers attempting to register shares constituting a substantial portion of their public float for resale by PIPE investors. Issuers have attempted to respond to the Staff’s comment letters in a variety of ways including the following:

• by referring the Staff to the issuer’s prior resale registration statements that included an equally large percentage of the issuer’s stock and noting they were declared effective with little, if any, reaction from the SEC. (The Staff appears to have rejected the argument that an issuer’s prior registration statements have any precedential value for purposes of evaluating newly-filed registration statements.)

• by asking the Staff to give effect to provisions in many PIPE contracts that limit the number of shares that investors may ultimately receive in these transactions for purposes of calculating the one-third test. For example, where convertible securities are issued in a PIPE, the conversion price may be subject to a downward adjustment upon the occurrence of specified events including a dilutive issuance of securities by the issuer or a decline in the issuer’s trading price over time. The adjustments are designed to protect investors against future dilution and essentially allow the investors to convert their securities into an increasingly greater number of underlying shares of the issuer’s common stock over time. Many PIPE transactions cap this dilution protection at 4.99% or 9.99% of the issuer’s outstanding stock (designed to avoid certain reporting requirements under the Securities Exchange Act of 1934 (the “Exchange Act”) and the “short-swing” trading restrictions under Section 16 of the Exchange Act). (The Staff has stated that it will ignore these contractual limitations and look only at the maximum number of shares proposed to be registered in relation to the issuer’s pre-PIPE public float to determine whether the registration is presumptively a primary offering.)

• by asking the Staff whether they may divide one large registration into two or more smaller registrations, each one constituting less than one-third of the issuer’s public float prior to the PIPE. (The Staff has announced that if two separate registration statements filed by the issuer attempt to register securities...
on behalf of the same investor (or its affiliates), then the second registration statement cannot be filed with the SEC until the later of six months after the effective date of the first registration statement or 60 days after “substantially all” the shares registered on behalf of the investor in the initial registration statement have been sold. This analysis will be performed on an individual basis for each investor, together with its affiliates. If an issuer wishes to rely on the 60-day alternative to support its second registration statement, the Staff indicated that the issuer may be required to deliver a signed representation to the SEC that the investor has in fact sold substantially all the shares registered in the first registration statement.)

THE IMPACT ON ISSUERS AND INVESTORS

Underwriter Status of Investors

If the proposed registration of securities sold in a PIPE transaction is deemed to be a primary offering on behalf of the issuer, the investors in the PIPE will be deemed statutory underwriters with respect to the offering and must be appropriately identified as such in the registration statement filed by the issuer. This requirement applies to each registration regardless of the form of registration statement used to register the securities. As with traditional underwritten primary offerings, underwriter status has a number of implications for investors. First, the investors would become subject to statutory liability under Section 11 of the Securities Act. Under Section 11, underwriters are liable for material misstatements or omissions of material fact in registration statements, subject to a due diligence defense. In addition, any profits earned on the resale of the PIPE shares by the investors may be deemed underwriting discounts and commissions. The Staff has indicated that the investors would retain their underwriter status for the duration of the transaction—that is, until all the shares covered by the registration statement are resold or until the registration statement is withdrawn by the issuer.

No Form S-3 Eligibility for Unseasoned Issuers

In order to register shares for sale by (or on behalf of) the issuer using a Form S-3 shelf registration statement, the issuer must be a “seasoned issuer” and have a public float—the aggregate market value of the voting and non-voting common equity held by its non-affiliates—of at least $75 million as of a date within 60 days prior to filing the registration statement. Issuers that do not meet this requirement (known as “unseasoned issuers”) must register the shares on a Form S-1 registration statement, which is the SEC’s basic long-form registration statement, a Form S-11 registration statement, which is the SEC’s basic long-form registration statement for REITs or a Form SB-1 or SB-2 registration statement, if they qualify as small business issuers. Form S-3 registration statements are shorter and generally less expensive to prepare than other registration statements because they allow an issuer to incorporate by reference the information included in issuer’s periodic and current reports previously filed under the Exchange Act, as well as information included in its Exchange Act reports filed after the registration statement is declared effective. Although certain issuers that are current in their filings under the Exchange Act will be permitted to incorporate by reference into a Form S-1 registration statement the information included in their previously filed Exchange Act reports, these issuers are not permitted to incorporate by reference from any Exchange Act reports filed after the Form S-1 is declared effective by the SEC (i.e., no “forward incorporation by reference”). Because most PIPE contracts require the issuer to keep the registration statement continuously effective over a minimum period of time (e.g., two years), unseasoned issuers must continue to file post-effective amendments to their registration statements to prevent them from going stale or otherwise update them as required for material developments. As a result, a purported secondary offering that is deemed a primary offering under the SEC’s new guidance will leave unseasoned issuers with a more burdensome registration process and more expensive PIPE, compared to seasoned issuers.

Offerings at a Fixed Price

Under Rule 415(a)(4), primary “at the market” offerings conducted on a delayed or continuous basis must be registered on a Form S-3 registration statement. Accordingly, unseasoned issuers, who do not qualify to use these forms for primary offerings, may not register shares for sale to the public at prevailing market prices. Instead, they must set a single, fixed price (not a price range) at which the shares will be sold under the registration statement prior to the time of the first sale. All sales under the registration statement must be made at this price. The Staff noted that the final price must be listed on the cover page of the prospectus included in the registration statement and that it will object to any attempt by issuers to change the offering price after it has been included in the final prospectus.
Potentially Greater Discount of the Sale Price

If issuers are unable to register for resale on behalf of investors some or all the shares issued in a PIPE transaction, investors will generally be required to rely on Rule 144 under the Securities Act to resell the restricted securities purchased in the PIPE transaction. Rule 144 generally permits investors to resell limited quantities of securities acquired in a PIPE beginning one year after the purchase date as long certain requirements are met by the investors and the issuer. However, because Rule 144 and other resale exemptions do not offer investors the same immediate liquidity provided by an effective resale registration statement, investors may begin demanding greater discounts to the purchase price of securities sold in PIPEs to compensate for their reduced liquidity.

ADDITIONAL GUIDANCE THROUGH THE COMMENT PROCESS ONLY

The Staff has announced that it does not expect to issue any written guidance on this issue other than through the comment letter process.

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