SECURITIES MARKETS

Nasdaq Requirement for Shareholder Approval of Private Financings

Determining whether a Nasdaq issuer must obtain shareholder approval of a private financing can be a time-consuming and complex process that often requires issuers to consult a number of different rules and guidelines in a limited amount of time. A thorough examination and understanding of these rules and regulations, particularly the over 100 published Nasdaq Interpretative Letters governing private placement financings, is critical for any issuer seeking to conduct one of these transactions and can assist the issuer in structuring its financing to avoid the need to obtain shareholder approval.

by Jeffrey T. Hartlin

The last 10 years have seen tremendous growth in the number and size of private placement financings by publicly-reporting companies, including those with securities traded on the Nasdaq Stock Market, LLC (Nasdaq).[1] For a number of Nasdaq issuers, private placements are a faster and much less burdensome option to raise funding than a registered public offering. To guard against the significant dilution to an issuer's shareholders that could otherwise result from these transactions, Nasdaq rules regulate the price and size of private placement financings that may be completed without prior shareholder approval. Unfortunately, these rules have not kept pace with a number of recent developments in private placements by public issuers and in many cases provide issuers with limited transparency as to whether a specific transaction would require shareholder approval. Because the shareholder solicitation and approval process can be costly and time-consuming, Nasdaq issuers often search for opportunities to structure their financings in a manner that would eliminate the need to obtain shareholder approval.

To assist issuers in understanding and applying its rules, Nasdaq has issued guidance in the form of Interpretative Material,[2] Frequently Asked Questions[3] and over 100 Staff Interpretative Letters addressing specific fact patterns and issues relating to private placement financings.[4] In some cases, Nasdaq has used the FAQs and Interpretative Letter process to effectively "adopt" both additional shareholder approval requirements and exceptions applicable to these transactions. However, reviewing each of these sources, particularly each of the Interpretative Letters, to determine whether shareholder approval is required can be extremely burdensome. This article outlines the steps that must be taken to determine whether shareholder approval is required under the primary Nasdaq rule governing private placement financings—Rule 4350(i)(1)(D)—and summarizes the Nasdaq's guidance under each of these sources.

Background

Nasdaq Stock Market Rule 4350(i)(1)[5] lists four categories of securities issuances that require prior shareholder approval. The first three categories include certain grants of equity compensation to an issuer's insiders, employees, and consultants,[6] issuances that would result in a change of control of the issuer (as determined under Nasdaq rules)[7] and certain issuances in connection with the issuer's purchase of stock or assets of another entity.[8] The last category, which is set forth in Nasdaq Marketplace Rule 4350(i)(1)(D), states that shareholder approval is required:

> In connection with a transaction other than a public offering involving: (i) the sale, issuance or potential issuance by the issuer of

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common stock (or securities convertible into or exercisable for common stock) at a price less than the greater of book or market value which together with sales by officers, directors or substantial shareholders[9] 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 (ii) the sale, issuance or potential issuance by the company of common stock (or securities convertible into or exercisable 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 for less than the greater of book or market value of the stock.

To determine whether shareholder approval of a private placement financing is required under Rule 4350(i)(1)(D), the issuer must take the following five steps:

1. Determine whether the issuance qualifies as a public offering.
2. Determine whether the issuance will be aggregated with any previous private placement by the issuer.
3. Determine whether the securities issued in the private placement are deemed to be sold at a discount.
4. Determine whether the number of securities deemed to be sold in the private placement constitutes 20 percent or more of the issuer's pre-transaction common shares outstanding.
5. Consider whether the issuer may be entitled to qualify for the limited "financial viability" exception provided under Rule 4350(i)(2).

Each of these steps is addressed below.

Step 1: Determine Whether the Issuance Is a Public Offering

By its terms, Rule 4350(i)(1)(D) does not require shareholder approval of any "public offering" of securities. Nasdaq's Interpretative Material (IM) provides useful guidance for determining whether an issuance constitutes a public offering under the rule.[10] IM-4350-3 states that a firm commitment underwritten securities offering registered with the Securities and Exchange Commission (SEC), as well as any other securities offering registered with the SEC that is "publicly disclosed and distributed in the same general manner and extent as a firm commitment underwritten securities offering," will be considered a public offering under Rule 4350(i)(1)(D). IM-4350-3 then identifies the following five factors that, among others, will be considered by Nasdaq to determine whether the issuance is a public offering.

1. *The type of offering*. In each Reviewed Letter in which Nasdaq determined that an issuance qualified as a public offering under Rule 4350(i)(1)(D), the offering was registered with the SEC[11] and conducted on a firm commitment or best efforts basis using either an underwriter or placement agent.[12] None of the Reviewed Letters asked Nasdaq to consider an issuer's self-directed offering so it is unclear under what circumstances, if any, these financings could be deemed to qualify as public offerings. However, because self-directed offerings are typically not marketed or distributed (*i.e.*, conducted) in the "same general manner" as underwritten offerings, presumably most would not qualify.[13]

2. *The manner in which the offering is marketed*. Traditional public offerings frequently include a coordinated and broad marketing effort. The Reviewed Letters cite the following marketing factors, among others, to support Nasdaq's determination that an issuance qualified as a public offering under Rule 4350(i)(1)(D):

- There are no restrictions on the type of investors who can participate in the offering;[14]
- The marketing effort will seek to include retail investors in the offering[15] and there is no limit on the number of retail investors who can participate;[16]
- The underwriters for the offering will select the offerees;[17]
- The issuer and agents are expected to meet with over 100 potential investors;[18] and
- The marketing effort will include a road show in four "major" US cities and conference calls with prospective international investors.[19]

3. *The extent of the offering's distribution*. Underwritten public offerings typically include a larger

number of investors than private placements. In the three Reviewed Letters in which Nasdaq cited the number of prospective investors to support its determination that the financings qualified as public offerings under Rule 4350(i)(1)(D), the transactions were expected to have 40–100, 100, and at least 150 investors, respectively.[20]

The Reviewed Letters also emphasize that to qualify as a public offering the group of investors must be diverse and include both retail and institutional participants.[21] Because the investor pool in traditional private placement financings often is limited to institutions (and perhaps individuals affiliated with the issuer), retail participation is a key metric used by Nasdaq to distinguish public offerings from private placements. In addition, IM-4350-3 implies that an issuance in which a substantial number of investors have a prior relationship with the issuer, or in which a substantial number of the offered securities are purchased by these investors, is more likely to be deemed a private placement than a public offering.[22]

4. *The offering price*. Underwritten "follow-on" public offerings typically have an offering price to the public at or around the issuer's recent trading price (often at a slight discount). Privately-placed securities, however, are frequently sold at a moderate, and in some cases a large, discount to the issuer's recent trading price. Although Nasdaq has not adopted a bright-line approach to this issue, the Reviewed Letters suggest that Nasdaq judges whether the formula for pricing the securities sold in the proposed offering is "consistent" with the formulas used to price other firm commitment follow-on public offerings completed during the same timeframe.[23] In a few Reviewed Letters, Nasdaq determined that registered offerings sold at discounts as high as 12 percent and 7–11 percent to the issuers' recent trading prices qualified as public offerings under Rule 4350(i)(1)(D).[24]

5. *The extent to which the issuer controls the offering and its distribution*. In a typical firm commitment or best efforts registered offering, the underwriter or placement agent exercises a significant degree of control over the offer and distribution of the issuer's securities and is generally responsible for arranging meetings with prospective investors and compiling the final list of investors. A substantial number of Reviewed Letters cited the issuers' limited or complete lack of control over the offering and distribution process as one of the primary factors supporting Nasdaq's determination that an issuance qualified as a public offering,[25] suggesting that issuers trying to obtain the public offering exception may benefit by limiting their involvement in the offer and distribution of securities.

Step 2: Determine Whether the Private Financing Will Be Aggregated with One or More Prior Transactions

If an issuer does not meet the public offering exception, it must determine whether its private placement financing falls under clause (i) or (ii) of Rule 4350(i)(1)(D) and therefore requires shareholder approval. However, an issuer may need to consider more than just the proposed offering. Although not addressed anywhere in the Nasdaq Marketplace Rules, in certain circumstances Nasdaq requires that issuers "aggregate" the securities issued in a proposed offering with those issued in one or more earlier private financings (or other transactions). If a prior transaction is aggregated with the proposed private financing, Nasdaq will essentially treat them as a single transaction for purposes of Rule 4350(i)(1)(D)[26] and evaluate the combined result of the transactions to determine whether shareholder approval is required.

Because the concept of aggregation is not discussed in the Nasdaq Marketplace Rules, issuers must (again) refer to the Interpretative Letters as their only source of guidance on the issue. The Reviewed Letters indicate that Nasdaq considers the following five factors to determine whether transactions will be aggregated for purposes of Rule 4350(i)(1)(D).[27] In most cases, Nasdaq determined *not* to aggregate the transactions.[28]

1. *The timing of the issuances*. The first factor is the amount of time that has elapsed between the transactions. Nasdaq has not adopted a "safe harbor" period that would automatically exempt two financings from aggregation; nor has it adopted a period within which transactions would automatically be

aggregated.[29] In one Reviewed Letter, as partial justification of a decision not to aggregate two private financings, Nasdaq noted that the transactions at issue were separated by approximately one year, which constituted a "substantial length of time."[30] However, the Reviewed Letters also indicate that two transactions can actually occur more closely in time and avoid aggregation. For example, Nasdaq determined not to aggregate two private placement financings that were separated by only 45–60 days, in one case, and approximately seven weeks, in another;[31] and in another instance, it even determined not to aggregate two concurrent private financings.[32] Based on the Reviewed Letters, the timing of the issuances appears to play a less significant role in the aggregation outcome than some of the other factors.

2. *The commonality of investors*. Nasdaq considers whether and to what extent investors in the earlier financing will participate in the proposed offering. A greater degree of investor overlap suggests that a subsequent private placement may be simply an extension (e.g., an additional closing) of a prior offering rather than an independent transaction.[33] The tone of the Reviewed Letters suggests that Nasdaq may give more weight to this factor than some of the others. In two of the four Reviewed Letters in which Nasdaq aggregated private placements for purposes of Rule 4350(i)(1)(D), for example, Nasdaq cited the commonality of investors as a significant factor in its determination, particularly when the investors in the prior transaction were expected to purchase more than a nominal amount of securities in the proposed offering.[34] In three Reviewed Letters in which Nasdaq determined not to aggregate transactions despite an overlap of investors, the highest (disclosed) percentage of shares that a repeat investor was expected to purchase in the proposed offering was 35 percent.[35]

The Reviewed Letters also suggest that when two transactions include some overlap in the investor pool, Nasdaq is less likely to "penalize" issuers if the overlapping investors are participating in the proposed offering pursuant to a right of first refusal or other contractual right obtained through a prior transaction with the issuer. In taking this approach, Nasdaq presumably acknowledges that many investors demand (and often obtain) the right to participate in one or more of an issuer's future financings as a condition to their investment as a means of preserving their equity position (*i.e.*, to avoid being diluted) even though the issuer may not have contemplated a subsequent financing at the time.[36] If a proposed offering includes current investors of the issuer, the Reviewed Letters indicate that Nasdaq may be more likely to aggregate if an overlapping investor negotiates the terms of the proposed financing (on behalf of the investors generally) or acts as the lead or largest investor in the proposed financing.[37]

3. *The existence of any contingencies between the issuances or transactions*. Substantially all of the nearly 40 Reviewed Letters in which Nasdaq determined not to aggregate two private placement financings noted that no contingencies existed between the transactions.[38] Because private financings are seldom contingent on the completion of other (independent) private placement financings, this factor may be more relevant in determining whether to aggregate a private placement financing with other types of private placement transactions (*e.g.*, where the issuer is using a combination of cash and privately-placed stock to acquire another company and the cash portion was generated from an earlier private financing of the issuer).[39]

4. *The commonality as to the use of proceeds*. Although Nasdaq considers whether proceeds raised from private financings will be used for the same or a related purpose, the Reviewed Letters suggest that this factor may not carry as much weight in the analysis as some of the other factors. In two Interpretative Letters, for example, Nasdaq noted that the overlapping use of proceeds (general working capital) was not a "determinative factor" for aggregating the transactions.[40]

5. *Whether the transactions are part of the same financing plan*. The final factor is whether the two transactions are part of the same plan of financing; that is, did the issuer contemplate the second transaction at the time it conducted the first transaction? In a number of Reviewed Letters in which Nasdaq determined not to aggregate private financings, it noted that the issuer's unexpected change in financial circumstances or other unforeseen events led to the

need for the subsequent financing.[41] These included, for example, delays in the receipt of certain regulatory approvals for a drug product,[42] unanticipated acceleration of the issuer's clinical trials[43] and a 45 percent decline in the issuer's stock price that resulted in a limitation in the amount of funding available pursuant to the issuer's prior financing.[44] In one instance in which it aggregated transactions, Nasdaq stated that its decision was based in part on the fact that a portion of the proceeds from the proposed financing would be used to redeem the securities issued in the first transaction, suggesting that the two transactions were part of the same financing plan.[45]

Based on the author's discussions with Nasdaq, issuers also should be aware that Nasdaq may take the position that separate private placements, although structured as independent transactions, are essentially part of a single plan of financing because the issuer "should have known" after the earlier financing that it would need to engage in one or more subsequent financings in the near-term to meet its ongoing capital requirements.[46]

Steps 3 and 4: Determine the Deemed Issue Price and Securities Deemed Issued

As set forth above, an issuer must obtain prior shareholder approval for any private placement financing in which:

- The issuer sells any securities at a price below the *greater of* the book and market values of the issuer's common stock or voting power and such securities, when added to the number of securities sold in the same transaction by the issuer's affiliates, constitute 20 percent or more of the issuer's pre-transaction outstanding shares;[47] or
- The number of securities sold constitutes 20 percent or more of the issuer's pre-transaction outstanding shares at an issue price less than the *greater of* the book and market values of the issuer's common stock or voting power.[48]

The Applicable Time of Measurement

To perform the calculation required under Rule 4350(i)(1)(D), the issuer must determine the applicable measurement time for selecting the book and market values of its common (*i.e.*, voting) stock and the number of common shares deemed outstanding. Under Rule 4350(i)(1)(D), the market value of an issuer's stock must be measured as of immediately prior to "the entering into of the binding agreement to issue the securities," regardless of when the securities are actually sold.[49] In the event the agreement is executed by the parties after 4 p.m. (Eastern Time), the issuer must use its market value as of 4 p.m. on the date of execution (or the immediately preceding business day if the agreement is executed on a date the markets are closed).[50] In the event the definitive agreement is executed before 4 p.m., the issuer must use its market value as of 4 p.m. on the immediately preceding business day.[51] To determine book value, the issuer must use the amount reported in its most recent SEC report filed prior to the date of the definitive agreement. Based on the Reviewed Letters, the timing calculation used to measure an issuer's market value also is used to determine the number of pre-transaction shares deemed outstanding for purposes of Rule 4350(i)(1)(D).

When two or more private placement financings are aggregated, the issuer must use the time of execution of the definitive agreement for the *earliest* aggregated transaction to establish the issuer's pre-transaction shares outstanding.[52] For example, if an issuer had 10,000,000 shares of common stock outstanding as of immediately prior to the first aggregated financing, the 20 percent threshold under Rule 4350(i)(1)(D) would be met once the issuer was deemed to have sold 2,000,000 or more shares in all of the aggregated transactions combined.

However, the Reviewed Letters indicate that Nasdaq may not necessarily use the same measurement time for purposes of conducting the price analysis and determining whether the securities are sold at a discount. Specifically, the letters indicate that in some cases the issuer must use the time of execution of the definitive agreement for the earliest aggregated transaction (consistent with the approach discussed above for purposes of determining the pre-transaction shares outstanding); in other cases, the issuer will be required to use the time of execution of the definitive agreement for the second (or later) transaction. Moreover, based on the author's discussions with Nasdaq, it

appears that Nasdaq may in certain circumstances consider using an interim date between the dates of the financing agreements to determine whether the securities sold in the second aggregated transaction are at a discount. Nasdaq has not explicitly outlined under what circumstances issuers should use one approach versus another. However, in one instance in which Nasdaq determined to use the time of execution of the definitive agreement of the *second* aggregated transaction for purposes of determining whether securities were issued at a discount, Nasdaq stated:

> For purposes of determining whether the issuance price is at least as much as market value, it is appropriate to use the closing bid price immediately prior to the binding agreement for the Proposed Transaction rather than that immediately prior to the original transactions. The more recent closing bid is used because of the changes in circumstances since entering into of the original agreements that led to the desire to consummate the Proposed Transaction and because of the significant changes in terms that would be reflected in the Agreement . . . .[53]

Accordingly, when an issuer has experienced a change in circumstances between two aggregated transactions, it may be required to assess the price at which the shares were sold in the second financing against its book and market values as of immediately prior to that (second) financing *even though the issuer is required to use the shares outstanding as of immediately prior to the earlier (first) financing to determine whether the 20 percent threshold has been met.* Issuers who encounter this issue may wish to consult with Nasdaq for guidance on the appropriate measurement time.

The Deemed Issue Price

Once the issuer has established the applicable date and time for making the calculation under Rule 4350(i)(1)(D), it must calculate whether the securities will be deemed sold at a price below the greater of the issuer's book and market values (*i.e.*, issued at a discount).[54] To complete this analysis, the issuer must determine three values:

1. the applicable book value of its common shares;
2. the applicable market value of its common shares; and
3. the deemed issue price of the securities sold in the private placement financing.

"Book value" is an issuer's shareholders' equity as set forth in its most recent public filing with the SEC.[55] "Book value per share" is an issuer's shareholders' equity divided by its total outstanding common shares.[56] The "market value" of the issuer's securities is the consolidated closing *bid* price.[57] Issuers may not use their closing price, last sale price or an average price in order to determine "market value" under Rule 4350(i)(1)(D).[58]

The price at which a security is deemed sold in a private financing depends on the type of security and its features.

Common Stock. Generally, the issuer will use the actual price at which the common shares are sold to the investors. If the sale price of the common stock is below the greater of the book and market values of the issuer's common stock, the shares are deemed sold at a discount under Rule 4350(i)(1)(D).

Convertible Securities (Excluding Warrants). For preferred stock and other securities convertible into or exercisable for common stock (excluding warrants issued in conjunction with common stock and other securities), the issuer must use the conversion or exercise price of the convertible security. If this price is at or above the greater of the book and market values of the issuer's common stock, the convertible security will not be deemed issued at a discount under Rule 4350(i)(1)(D) unless, as discussed below, the security contains an economic anti-dilution or similar conversion price adjustment provision.

Warrants. In many public company private financings, warrants are issued along with the sale of common stock, preferred stock and/or promissory notes.[59] Although not set forth in the Nasdaq Marketplace Rules, Nasdaq uses a separate method for "pricing" these warrants. Specifically, Nasdaq attributes a *market* value of $0.125 for each privately-placed warrant issued in conjunction with

common stock (or securities convertible into common stock).[60] As a result, in order for one of these warrants *not* to be deemed issued at a discount under Rule 4350(i)(1)(D), the sale price allocated to the warrant in the financing must be at least the sum of $0.125 per warrant *plus* any amount by which the greater of the issuer's book and market values exceeds the warrant exercise price (*i.e.*, the amount by which the warrant is "in-the-money" at the time of issuance). Therefore, "consider a company with a market value of common stock of $10 per share. In the transaction, the company will issue units consisting of one share of common stock and one warrant exercisable at $10 per share. Nasdaq will consider the common stock to be issued at a discount unless the issuance price of the units is at least $10.125…"[61]

If an issuer sells a warrant exercisable for a fraction or multiple of one share for each share of common stock (or common stock equivalent) sold, the $0.125 attribution price must be proportionately adjusted. For example, to issue a warrant exercisable for 0.25 shares for each share of common stock sold in the financing, the issuer would use a warrant attribution value of $0.03125 ($0.125*0.25);[62] and to issue a warrant exercisable for two shares for each share of common stock sold, the issuer would use a warrant attribution value of $0.250 ($0.125*2).

Nasdaq's attribution of $0.125 per warrant share applies regardless of the value assigned to the warrant by the issuer for accounting (or any other) purposes. As a result, this value does not take into consideration factors typically used by issuers in valuing convertible securities (such as warrants), including the historical volatility of the issuer's underlying common stock, the issuer's stock price or the term of the convertible security. In a Bulletin issued in late 2006, Nasdaq announced that it was considering a change in its warrant attribution method.[63] The Bulletin proposed a formula for valuing warrants based on a "seven-step process which takes into account the offering price, the intrinsic value of the warrant, the number of warrants, the price paid for the warrants, and the offering proceeds, to determine the share equivalent for each warrant in question, which is multiplied by the closing bid price of the common stock to find the dollar value of each warrant." As of the date of this article, Nasdaq has not indicated whether it has determined to adopt the proposal set forth in the Bulletin or otherwise modify its approach for valuing warrants.

Conversion Price Adjustments. Convertible securities issued in private financings by public issuers often contain some form of anti-dilution or other "downside" price protection. Although both the form of protection and the events triggering the protection vary from one transaction to another, typically the result is the same—a reduction in the conversion or exercise price of the convertible security. Nasdaq understands that if triggered, these adjustment provisions could result in substantial dilution to an issuer's shareholders long after a private placement financing has closed. To address this risk, Nasdaq takes the position that "[t]he presence of any provision, including an anti-dilution provision (except for stock splits or similar changes to the company's capitalization), which *could cause* the conversion price of a security to be reduced to below the market value immediately before the entering into of the binding agreement, will cause the transaction to be viewed as a discounted issuance."[64] The Reviewed Letters and FAQs emphasize that Nasdaq distinguishes between economic or "price-based" anti-dilution provisions applicable to a discrete group of securities, on the one hand, and anti-dilution provisions relating to stock splits, stock combinations, stock dividends and similar events applicable to all of the issuer's outstanding securities, on the other.[65] Only the former would cause the convertible security to automatically be deemed issued at a discount under Rule 4350(i)(1)(D).[66]

If the initial conversion price of a security with an "economic" anti-dilution or similar adjustment provision is set at a premium to the issuer's book and market values, the issuer can avoid having the shares automatically deemed sold at a discount by setting a conversion or exercise price "floor." The floor typically would provide that notwithstanding the adjustment feature, the conversion or exercise price of the convertible security could not be reduced to an amount below the greater of the issuer's book and market values as of immediately prior to the execution of the definitive agreement under which the security is issued.[67]

Cash Payments. Given the rigid pricing interpretations discussed above, issuers may be pleasantly surprised to learn that cash payments made to a placement agent, broker, or other service provider as part of a private placement transaction, as well as any cash dividend and interest payments to be made on the privately-placed securities, are disregarded for purposes of determining whether the securities are issued at a discount under Rule 4350(i)(1)(D).[68] This differs from Nasdaq's treatment of compensation, dividends, and interest paid in the issuer's shares, however, which is discussed below.

The Number of Securities Deemed Sold (the Numerator)

If the issuer's securities are sold at a discount under Rule 4350(i)(1)(D), it must then calculate whether the number of shares of common stock (or voting power) deemed issued equals 20 percent or more of its pre-transaction shares outstanding. As discussed above, issuers would need to include any privately-placed securities issued in an aggregated transaction as well.

Based on the Reviewed Letters, for purposes of Rule 4350(i)(1)(D), Nasdaq requires that issuers calculate the maximum number of common shares issued *or issuable* as part of the private placement financing. This includes the following:

- Securities issued after the initial closing date for the offering in one or more subsequent closings;
- Securities issued in satisfaction of the issuer's interest, dividend, or other payment obligations;[69]
- "Additional" securities issued or issuable pursuant to an economic, price-protection, or similar anti-dilution clause;[70]
- Securities issued in a subsequent financing pursuant to an investor's right of first refusal granted in the private placement;[71] and
- Securities issued to placement agents, brokers, "finders," or other service providers as part of the financing transaction.[72]

As a result, when an issuer determines that shareholder approval is not initially required, it may need to reassess its determination in the future if additional securities become issuable in connection with the private placement.

Securities that may not be converted into common (or voting) stock are excluded from the number of shares deemed issued under Rule 4350(i)(1)(D). To capitalize on this exception, issuers selling convertible securities often impose a limit (known as a "cap") on the number of shares of common (or voting) stock that can be issued upon conversion or exercise of convertible securities "such that there cannot, under any circumstances, be an issuance of 20 percent or more of the common stock or voting power previously outstanding without prior shareholder approval."[73] However, Nasdaq allows issuers to exclude the securities above the cap for purposes of Rule 4350(i)(1)(D) only if the following requirements are met:

- The prohibition on conversion of the portion of the security being excluded must apply for the *entire* life of the security unless the security is approved by shareholders;[74]
- The portion of the security being excluded cannot have any voting rights other than rights required under applicable state law or certain limited rights provided by contract (*e.g.*, under the issuer's certificate or articles of incorporation) unless the security is approved by shareholders;[75] and
- Any other securities issued in the private placement with the security being excluded may not participate in the vote to approve the excluded security (*e.g.*, any common stock issued in conjunction with the excluded preferred stock may not vote to approve the preferred stock).[76]

Nasdaq imposes a further requirement on issuers who seek to use a conversion cap as part of a private placement financing that also includes an "alternative outcome" provision. An alternative outcome is generally "any change in the terms of [a] transaction that occurs as a result of a shareholder vote."[77] Examples of alternative outcomes include penalties imposed on issuers, such as an increase in the coupon rate or conversion rate on securities issued to investors in the event the issuer's shareholders fail to approve the transaction, as well as benefits to issuers, such as a reduction in a coupon or conversion rate in

the event the issuer's shareholders approve the transaction.[78] Nasdaq believes that an alternative outcome provision has "a coercive effect on the shareholder vote, and thus may deprive shareholders of their ability to freely exercise their vote."[79] As a result, when an issuer conducts a private placement financing that combines a conversion cap with an alternative outcome, Nasdaq essentially disregards the cap and prohibits the issuance of *any* underlying common (or voting) securities, including shares under the cap, until the date the issuer's shareholders *vote* to approve the transaction in which the securities are issued.[80] If shareholders ultimately approve the transaction, the cap becomes moot and all securities can be converted. On the other hand, if shareholders fail to approve the transaction, the original cap is reinstated after the vote and issuers are subsequently permitted to issue common (or voting) stock underlying the convertible securities in an amount up to the cap.[81]

Nasdaq provides issuers with an additional opportunity to exclude warrants from the number of shares deemed issued under Rule 4350(i)(1)(D). Specifically, any shares underlying warrants that (i) cannot be exercised during the six-month period following the closing of the transaction,[82] and (ii) have an exercise price equal to or greater than the issuer's pre-transaction book and market values, as determined using the criteria discussed above, are excluded from the number of shares deemed issued under Rule 4350(i)(1)(D).[83] The Reviewed Letters address a number of transactions in which issuers structured their warrants to meet these criteria and therefore were permitted to exclude them from the calculation.[84]

The Number of Pre-Transaction Shares Outstanding (the Denominator)

To determine the percentage of securities deemed issued under Rule 4350(i)(1)(D), the issuer generally must use all of its outstanding *common* shares. However, the issuer's treasury shares and any outstanding shares held by a subsidiary of the issuer are excluded.[85] Common shares reserved for future issuance also are excluded.

As discussed above, when two or more private placement financings are aggregated, the issuer must use the number of issued and outstanding common shares as of immediately prior to the earliest aggregated transaction to determine whether shareholder approval is required.[86] Therefore, any securities issued in a transaction that is aggregated with the proposed issuance are included in the numerator but excluded from the denominator.

Step 5: Consider the Financial Viability Exception

Nasdaq Stock Market Rule 4350(i)(2) provides one exception to the shareholder approval requirements under Rule 4350(i)(1). To qualify for the exception, the issuer must submit a written application to Nasdaq's Listing Qualifications Department in advance of issuing the securities that convincingly demonstrates that a delay caused in obtaining shareholder approval would "seriously jeopardize the financial viability of the issuer" and that the issuer's audit committee (or comparable body of solely independent, disinterested directors) has expressly approved the issuer's reliance on the exception.[87] If the Listing Qualifications Department grants the exception, the issuer must inform its shareholders in writing and disclose publicly through a "news media" that it is relying on the exception and must provide additional information regarding the proposed issuance and the circumstances justifying the exception at least 10 days prior to the date the securities are issued.[88] Based on the Reviewed Letters, it appears that Nasdaq only grants the exception to issuers who run the risk of insolvency or bankruptcy if immediate financing is unavailable.

Obtaining Shareholder Approval

In the event the issuer is required to obtain shareholder approval under Rule 4350(i)(1)(D), the minimum vote necessary to approve the financing is a majority of the total votes *cast* on the proposal.[89] The votes may be cast in person, by proxy at a meeting of shareholders or by written consent in lieu of a special meeting to the extent permitted by applicable state and federal law and rules.[90]

NOTES

1. According to PlacementTracker, a provider of research, data, and analytics covering the private investment in public equity (PIPE) market,

approximately 450 PIPEs were completed in 1997 for aggregate gross proceeds of $4.74 billion. By comparison, issuers completed approximately 1,450 PIPEs for aggregate gross proceeds of $83..4 billion in 2007. (Available at *http://www.sagientresearch.com/pt/.*)

2. Nasdaq's "Interpretative Material" appears immediately following selected Marketplace Rules.

3. Nasdaq's Frequently Asked Questions—Listing Qualifications—Corporate Governance (FAQs) are *available at http://www.nasdaq.com/about/FAQsCorpGov.stm*.

4. According to Nasdaq's master index of Staff Interpretative Letters (*available at http://www.nasdaq.com/about/StaffInterpretativeLettersMaster.pdf*), a total of 108 Interpretative Letters regarding shareholder approval of private placements under Rule 4350(i)(1)(D) have been issued through October 29, 2008 (Interpretative Letters 2002-1 through 2008-18). These Interpretative Letters are collectively referred to in this article as the "Reviewed Letters."

5. The full text of Nasdaq Stock Market Rule 4350 is *available at http://www.cchwallstreet.com*.

6. Rule 4350(i)(1)(A). Rule 4350(i)(1)(A) states that shareholder approval is required "when a stock option or purchase plan is to be established or materially amended or other equity compensation arrangement made or materially amended, pursuant to which stock may be acquired by officers, directors, employees, or consultants," subject to certain exceptions. Issuers may easily overlook this rule in the context of a private placement financing. However, Nasdaq considers the sale of any securities to an officer, director, employee, or consultant of the issuer or any affiliate of one of the foregoing parties at a discount as compensation to the officer, director, employee or consultant in an amount equal to the discount. (Interpretative Letters 2003-6, 2005-38, 2006-38, 2006-39, 2007-9, 2007-20, 2007-25, 2008-5, 2008-7 and 2008-9.)

7. Rule 4350(i)(1)(B). In certain circumstances, a private placement financing may constitute a change of control under Rule 4350(i)(1)(B).

8. Rule 4350(i)(1)(C).

9. "An interest consisting of less than either 5 percent of the number of shares of common stock or 5 percent of the voting power outstanding of an issuer or party shall not be considered a substantial interest or cause the holder of such an interest to be regarded as a substantial security holder." (Nasdaq Stock Market Rule 4350(i)(5).)

10. IM-4350-3 encourages issuers to consult with Nasdaq to determine if a particular issuance is a "public offering" for purposes of Rule 4350(i)(l)(D). Issuers should note that in all Reviewed Letters in which Nasdaq considered this issue, it was determined that the proposed financing did indeed qualify as a public offering under Rule 4350(i)(1)(D).

11. Although IM-4350-3 cautions that registering an offering with the SEC is not by itself sufficient to qualify it as a public offering, registration appears to be a requirement to meet the exception.

12. Interpretative Letters 2004-17, 2004-24, 2004-42, 2005-47, 2006-2, 2006-25, 2007-22, and 2007-24.

13. Self-directed public offerings are commonly referred to as "direct public offerings" or "DPOs."

14. Interpretative Letters 2004-42, 2005-47, 2006-25, 2007-22, and 2007-24.

15. Interpretative Letter 2004-42.

16. Interpretative Letter 2006-25.

17. Interpretative Letter 2006-25.

18. Interpretative Letters 2004-17, 2006-2, and 2006-25.

19. Interpretative Letter 2006-2.

20. Interpretative Letters 2006-25, 2006-2, and 2004-17, respectively.

21. Interpretative Letters 2004-17, 2006-25, and 2007-24.

22. Interpretative Letter 2006-2. However, Nasdaq may give issuers more latitude when an investor with a prior relationship with the issuer is participating in the proposed offering through a contractual right obtained as part of a prior transaction between the issuer and the investor (*e.g.*, a right of first refusal), particularly if the prior transaction was approved by shareholders. (Interpretative Letter 2004-38.)

23. Interpretative Letters 2004-17, 2004-24, and 2004-42. In one instance, to support its determination that a best efforts offering being conducted with two placement agents qualified as a public offering, Nasdaq noted that the offering price, which was expected to be a 2-10 percent discount to the issuer's trading price, was "comparable to public secondary firm commitment underwritten transactions around the same period." (Interpretative Letter 2004-17.)

24. Interpretative Letters 2004-24 and 2004-42, respectively. In Interpretative Letter 2004-24, Nasdaq noted that the 12 percent discount was "comparable to similar transactions around the same period."

25. Interpretative Letters 2004-17, 2004-42, 2006-2, 2006-25, and 2007-24.

26. Note that although the aggregation principle also applies to mergers, acquisitions, stock purchases, asset purchases and similar transactions in which the issuer delivers securities as full or partial consideration, this article considers only the aggregation of two or more private placement financings.

27. Interpretative Letters 2002-1 and 2003-1. Through two interpretative releases, the SEC has identified five factors that must be considered when determining whether two or more transactions must be integrated for purposes of assessing whether registration is required. These factors, the majority of which overlap with Nasdaq's five aggregation factors, are whether: (1) the different offerings constitute a single plan of financing; (2) the offerings involve the issuance of the same class of security; (3) the offerings are made at or about the same time; (4) the same type of consideration is to be received; and (5) the offerings are made for the same general purpose (SEC Release 33-4434 (December 6, 1961) and SEC Release No. 33-4552 (November 6, 1962)). In Interpretative Letter 2004-36, Nasdaq justified a decision not to aggregate two transactions by relying in part on the fact that the transactions involved the issuance of two different classes of securities (common stock and convertible preferred stock), perhaps giving weight to one of the SEC's criteria for assessing integration.

28. Nasdaq determined to aggregate transactions in only four of the over 50 Reviewed Letters in which it analyzed the issue: Interpretative Letters 2003-39, 2004-12, 2004-51, and 2005-40.

29. Although The American Stock Exchange (AMEX) has similarly declined to adopt a "safe harbor" period for aggregation purposes, AMEX's aggregation guidance provides that transactions separated by six months or more will generally not be aggregated "absent other compelling factors." *Available at http://www.amex.com/?href=/equities/howToLst/AddnlListingReqs.html*. The SEC has adopted a similar six-month integration "safe harbor" for two or more transactions completed pursuant to Regulation D promulgated under the Securities Act of 1933, as amended (Rule 502(a)).

30. Interpretative Letter 2004-111.

31. Interpretative Letters 2003-10 and 2007-15, respectively. There are a number of other examples in which Nasdaq held that two private offerings occurring less than six months apart would not be aggregated. Interpretative Letters 2004-50 (approximately four months between transactions), 2007-13 (approximately five months between transactions), and 2007-17 (approximately three months between transactions).

32. Interpretative Letter 2003-13.

33. This frequently occurs, for example, when an issuer and investors structure a private placement to occur in multiple closings (*i.e.*, "tranches"), with a subsequent closing scheduled for a future definitive date, or contingent on the issuer reaching a financial or developmental milestone.

34. Interpretative Letters 2003-39 and 2004-51. In Interpretative Letter 2003-39, Nasdaq determined to aggregate two transactions because they involved the "same single investor" and occurred close in time. However, the Interpretative Letter did not disclose how "close in time" the transactions occurred, so it is unclear how much weight Nasdaq assigned to each factor. In another instance, Nasdaq determined to aggregate the issuer's two financing transactions because the only two investors in the first financing were expected to purchase up to one-third of the securities to be issued in the second financing. (Interpretative Letter 2004-51.) In Interpretative Letter 2007-9, Nasdaq noted that it determined not to aggregate two transactions in part "on the assumption that there is not significant overlap between the investors" in the two transactions, but that its determination "may change" if this assumption proved to be incorrect. Nasdaq included a similar caveat in Interpretative Letter 2008-6.

35. Interpretative Letter 2007-19. Interpretative Letters 2005-31 (25 percent), 2005-38 (24 percent), 2006-6 (30 percent), 2007-32 (30 percent), and 2008-6 (25 percent).

36. Interpretative Letters 2005-38 and 2008-6.

37. Interpretative Letters 2003-40, 2005-38, and 2006-6.

38. Interpretative Letters 2003-10, 2003-13, 2003-21, 2003-25, 2003-32, 2003-40, 2003-41, 2004-1, 2004-36, 2004-49, 2004-50, 2004-59, 2004-67, 2004-74, 2004-85, 2004-106, 2004-111, 2005-19, 2005-20, 2005-23, 2005-31, 2005-32, 2005-38, 2006-6, 2007-3, 2007-7, 2007-9, 2007-15, 2007-17, 2007-19, 2007-27, 2007-32, and 2007-34.

39. None of the Reviewed Letters address a proposed private placement financing that is expressly contingent on the completion of a prior private placement financing.

40. Interpretative Letters 2003-40 and 2003-41.

41. Interpretative Letters 2005-32, 2005-38, 2006-6, 2007-9, 2007-13, 2007-15, 2007-17, 2007-32, and 2007-34.

42. Interpretative Letter 2005-32.

43. Interpretative Letter 2007-32.

44. Interpretative Letter 2007-34.

45. Interpretative Letter 2005-40.

46. Nasdaq appears to be focused on "serial" private placement issuers whose historical cash "burn" rates provide a clear indication that such issuers would need to engage in multiple financings in a relatively close period of time to meet their ongoing financial needs.

47. Rule 4350(i)(1)(D)(i).

48. Rule 4350(i)(1)(D)(ii). "Voting power" refers to the aggregate number of votes that may be cast by holders of those securities outstanding that entitle the holders thereof to vote generally on all matters submitted to the issuer's security holders for a vote. (Nasdaq Stock Market Rule 4350(i)(4).) Although it may appear subtle, the difference between Rule 4350(i)(1)(D)(i) and (ii) is significant. Under the former, even if only a single share is sold by the issuer at a discount, the issuer could be required to obtain shareholder approval depending on the amount of sales by its affiliates (at any price).

49. FAQs—Shareholder Approval—Private Placements.

50. FAQs—Shareholder Approval—Private Placements. Note that Nasdaq allows issuers to use a different measurement date for pricing its securities when mandated by applicable federal securities rules (*e.g.*, tender offer rules) (Interpretative Letter 2005-26).

51. FAQs—Shareholder Approval—Private Placements.

52. Interpretative Letters 2003-39, 2004-3, 2004-12, and 2004-51.

53. Interpretative Letter 2006-19. "For determining whether the exercise price is at a discount to the market value, the Exercise Price Change is considered to be a new transaction because of the amount of time that has elapsed since the original transactions and the significant changes in circumstances since the original transactions giving rise to the company's need to seek additional sources of financing." (Interpretative Letter 2008-2.) Interpretative Letter 2004-12.

54. By contrast, for purposes of determining whether securities are issued at a discount under Rule 4350(i)(1)(A), it appears that only the issuer's "market value" is used. (FAQs—Shareholder Approval—Private Placements and Interpretative Letters 2007-20 and 2007-25.)

55. FAQs—Shareholder Approval—Private Placements. The FAQs state that book value can be based on the shareholders' equity and shares outstanding as reported in an issuer's report on Form 8-K or Form 6-K (as opposed to solely an annual or quarterly report).

56. For determining total shares outstanding, the issuer should use the amount reported with the issuer's shareholders' equity. Note that, although the FAQs state that book value per share is based on the "total shares outstanding," Nasdaq has confirmed that total common shares outstanding must be used.

57. Issuers can obtain their consolidated closing bid price by calling their representative at Nasdaq's Market Intelligence Desk (646.344.7800) or Nasdaq's MarketWatch Department (800.537.3929).

58. FAQs—Shareholder Approval—Private Placements.

59. These securities often are jointly referred to as "units" whereby, for example, one unit represents one share of the issuer's common stock and a warrant to purchase one share (or a fraction or multiple of one share) of common stock. Warrants are frequently referred to as "sweeteners" in these transactions. Issuers routinely offer them to entice investors to participate in the financing and/or to reduce the discount (or even obtain a premium) on the sale price of the other securities being sold in the financing.

60. FAQs—Shareholder Approval—Private Placements.

61. FAQs—Shareholder Approval—Private Placements. Interpretative Letters 2007-5 and 2007-19.

62. Interpretative Letters 2005-16 and 2007-5.

63. The Bulletin is *available at www.nasdaq.com/about/Warrant_Solicitation_102606.pdf*.

64. (Italics added) FAQs—Shareholder Approval—Private Placements. In the context of warrants, Nasdaq has referred to a form of anti-dilution adjustment provision that would cause the exercise price to automatically be deemed to be below the greater of book or market value as an "economic dilution adjustment" feature (Interpretative Letter 2005-16), a "reset" or other "price-based adjustment" provision (Interpretative Letter 2006-15) or a "market-price" or "exercise-price" anti-dilution adjustment provision (Interpretative Letter 2004-106). Interpretative Letters 2006-19, 2006-28, 2006-40, and 2007-32. Presumably, "future priced" convertible securities with a conversion or exercise price linked to a percentage discount to the market price of the issuer's underlying common stock at the time of conversion or exercise also would be deemed issued at a discount for purposes of Rule 4350(i)(1)(D). IM-4350-1.

65. The SEC uses a similar approach in another context pursuant to Rule 416 of the Securities Act of 1933, as amended.

66. Interpretative Letters 2003-6, 2003-22, 2003-42, 2004-12, 2004-20, 2004-106, 2005-16, 2006-34, 2007-19, 2007-32, and 2008-13. An example of this type of anti-dilution would provide that in the event the issuer sells any shares of common stock at a price below the exercise price of a warrant, the warrant exercise price would automatically be reduced to the price at which the shares of common stock are sold.

67. Interpretative Letters 2005-21 and 2005-38 for examples in which issuers used a conversion price floor to avoid having their shares deemed sold at a discount in light of anti-dilution provisions.

68. Interpretative Letters 2007-5 and 2007-7.

69. Interpretative Letters 2004-45, 2004-106, and 2005-9. Private placements of convertible preferred stock and convertible promissory notes often provide for mandatory dividend and/or interest payments. Many issuers prefer to pay their dividend and interest obligations in the issuer's stock in order to preserve cash. Based on the author's discussions with Nasdaq, any securities that could be issued as part of the transaction, including securities issuable after the closing, are treated as if they were issued at the time of closing.

70. Interpretative Letter 2008-6.

71. Interpretative Letter 2008-7. To avoid double-counting, securities issued pursuant to a definitive agreement for a prior private placement are not applied to any other (subsequent) private placement for purposes of Rule 4350(i)(l)(D) even if the issuance is triggered by or effected concurrently with the subsequent private placement.

72. Interpretative Letters 2005-9 and 2007-7.

73. IM-4350-2.

74. IM-4350-2, FAQs—Shareholder Approval—Alternative Outcomes & Defective Share Caps and Interpretative Letters 2006-38, 2006-39, 2006-43, and 2007-20.

75. For examples of permissible voting rights, see Interpretative Letters 2005-14 (preferred stock is non-voting, except as otherwise required by Delaware law and subject to a right of its holders to consent to any amendment of its terms) and 2007-23 (convertible preferred stock is non-voting, but has the right to consent to any amendment of its terms and to the creation and issuance of any capital stock or debt securities that rank equal or senior to the convertible preferred stock).

76. IM-4350-2 and Interpretative Letters 2006-38, 2006-39, 2006-43, and 2007-20. For example, if the issuer completes a private placement in which it issues common stock and preferred stock that is only convertible into common stock if the issuer obtains shareholder approval, the common stock issued in the financing may not vote to approve the preferred stock for purposes of Rule 4350(i)(1)(D).

77. FAQs—Shareholder Approval—Alternative Outcomes & Defective Share Caps.

78. FAQs—Shareholder Approval—Alternative Outcomes & Defective Share Caps and Interpretative Letter 2002-6 (issuer required to pay an investor a 5 percent fee if the issuer's shareholders do not approve a private placement), 2003-4 (in the event shareholder approval is not obtained, investors would receive a greater amount of substitute warrants with an exercise price equal to or greater than the market value on the date of the definitive agreement for the original transaction), 2003-14 (if the issuer's shareholders do not approve a private placement, the notes issued in the transaction must be repaid upon demand by the investors at any time 30 days after the shareholder vote) and 2006-21 (issuer required to repurchase warrants sold to investors if the issuer's shareholders do not approve the conversion of preferred stock and the exercise of the warrants). The FAQs and Reviewed Letters indicate that the materiality of an alternative outcome is irrelevant; even a potentially inconsequential change in the terms of a transaction based on a successful or failed shareholder vote would constitute an alternative outcome. (FAQs—Shareholder Approval—Alternative Outcomes and Defective Share Caps.)

79. IM-4350-2.

80. Nasdaq refers to a cap combined with an alternative outcome that violates this rule as a "defective share cap." (FAQs—Shareholder Approval—Alternative Outcomes and Defective Share Caps.) Issuers should note that although IM-4350-2 states that if a transaction has an alternative outcome, "no shares may be issued prior to the approval of shareholders,"

in the Reviewed Letters and the FAQs, Nasdaq has applied this rule in connection with share caps to mean that no common shares (or voting power) underlying the convertible securities subject to shareholder approval may be issued prior to the shareholder vote. (FAQs—Shareholder Approval—Alternative Outcomes & Defective Share Caps and Interpretative Letters 2002-6, 2003-14, 2005-14, 2005-17, 2006-21, 2006-38, 2006-39, 2006-43 and 2007-20.)

81. FAQs—Shareholder Approval—Alternative Outcomes and Defective Share Caps.

82. Note that the requirement is based on the closing of the transaction rather than the date of the definitive agreement for the transaction (if different). Interpretative Letter 2007-32, which indicates that if a warrant is issued after the closing of the transaction, the six-month period starts on the date the warrant is issued (rather than the closing date).

83. FAQs—Shareholder Approval—Private Placements. Interpretative Letter 2004-70 applied the same rule to other convertible securities referred to as "Additional Investment Rights," which suggests that this exception may be applicable to convertible securities generally.

84. Interpretative Letters 2004-70, 2005-21 (citing a prohibition on exercisability for 180 days, rather than six months), 2005-38, 2005-56, 2006-10, 2006-34 (citing 180 days), 2007-13, and 2007-32. Interpretative Letter 2007-19.

85. Rule 4350(i)(3).

86. Interpretative Letters 2003-39 and 2004-3.

87. A list of other factors that should be addressed by issuers in their written applications is set forth under FAQs—Shareholder Approval—Financial Viability Exception.

88. According to Interpretative Letter 2005-42, Nasdaq has no basis on which to waive the requirements of Rule 4350(i)(1)(D)(ii) (and presumably 4350(i)(1)(D) generally) other than through the financial viability exception under Rule 4350(i)(2). Interpretative Letters 2004-29, 2004-87, 2005-51, 2006-4, 2007-4, 2008-12, 2008-14, and 2008-18 provide examples where Nasdaq granted an exception from the shareholder approval requirement for a private placement financing pursuant to Rule 4350(i)(2).

89. Rule 4350(i)(6).

90. Rule 4350(i)(6).