

# Understanding the Securities Exchange Shareholder Vote Requirements (“the 20% Rule”) in the Context of Financings

Dave Donohoe

President

Donohoe Advisory Associates LLC  
[ddonohoe@donohoeadvisory.com](mailto:ddonohoe@donohoeadvisory.com)

David Compton

Senior Consultant

Donohoe Advisory Associates LLC  
[dcompton@donohoeadvisory.com](mailto:dcompton@donohoeadvisory.com)

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Anna Pinedo

Partner

Mayer Brown LLP  
[apinedo@mayerbrown.com](mailto:apinedo@mayerbrown.com)

Brian Hirshberg

Counsel

Mayer Brown LLP  
[bhirshberg@mayerbrown.com](mailto:bhirshberg@mayerbrown.com)

# Understanding the Nasdaq 20% Rule in the Current Financing Environment

# Nasdaq Listing Rule 5635 Requires Shareholder Approval for Certain Types of Transactions:

- Issuances that may exceed 20% of the pre-transaction total shares outstanding (“tso”) or voting power that are priced at less than the “Minimum Price”
- Sales by officers, directors and substantial shareholders (5% equity ownership or voting interest) will be aggregated with shares issued by the company

# Issuances that may result in a “change of control”

- General Rule of Thumb: If a transaction results in an investor or group of affiliated investors obtaining a 20% interest, or the right to acquire such interest, in the issuer on a post-transaction basis, the transaction will constitute a change of control for Nasdaq purposes (it does not matter whether the shares are priced above or below market)
- Nasdaq’s determination may also be impacted by factors such as overly restrictive covenants or board designation rights
- Notwithstanding, an exception exists for pre-existing control positions that are not displaced by the transaction

**Issuances that may exceed 20% of the total shares outstanding (“tso”) or voting power of the issuer if they are connected with the acquisition of stock of another company or, more generally, with the acquisition of any asset(s)**

- Nasdaq will include all potential equity issuances, including earn-out provisions
- This applies to both above and below market issuances

# Nasdaq's Application of the Rules Generally:

- The rules apply to issuances of equity securities and any security convertible into or exercisable for equity securities
- Where shareholder approval is required, the standard is a majority of votes cast
- Shareholder approval may be obtained through the use of a proxy statement or information statement
- **“Minimum Price”** is the lower of:
  - the Nasdaq Official Closing Price (“NOCP”)(as reflected on Nasdaq.com); or
  - the average NOCP of the common stock (as reflected on Nasdaq.com) for the five business days immediately preceding the signing of the binding agreement.

## Nasdaq's Application of the Rules Generally *(cont'd)*

- In assessing the potential for an issuance in excess of a Nasdaq cap/limitation, Nasdaq looks at what is possible not what is likely
- Prepaid warrants are deemed a common stock equivalent in an offering provided that they do not have price protection and are offered to all offering participants

## **Use of Share Caps and Pricing Floors to avoid exceeding the Nasdaq shareholder approval thresholds**

- When the terms of the securities being offered create the potential for an issuance in excess of 20% at less than the Minimum Price, the company may avoid the need for up-front shareholder approval by including a cap on the number of shares that can be issued or a floor on the conversion price, such that no securities may be issued in excess of 19.9% of the pre-transaction tso without shareholder approval

## Interpretive Material Regarding the Use of Share Caps or Pricing Floors –Alternative Outcome Transactions

- IM 5635-2 indicates that share caps and price floors are acceptable mechanisms to avoid the need to obtain shareholder approval prior to the completion of the transaction, provided:
  - The cap or floor remains in place for the life of the security or until shareholder approval is obtained (*e.g.*, a cap which is only in place while an issuer is listed on Nasdaq will be deemed defective)
  - Any shares issued pursuant to such a cap would not be eligible to vote with the shareholders on the removal of the cap or approval of the deal or any aspect of the deal
  - Shares owned by an investor participating in the offering prior to the offering may be voted in favor of removing the cap

## **Interpretive Material Regarding the Use of Share Caps or Pricing Floors –Alternative Outcome Transactions *(cont'd)***

- Caps may not be used in connection with the issuance of securities that include “penalty” provisions or “sweeteners” (referred to as “alternative outcome transactions”), which are triggered based upon the outcome of the shareholder vote
  - A right of redemption would constitute a penalty provision unless the proceeds are held in escrow pending the shareholder vote

## **Interpretive Material Regarding the Use of Share Caps or Pricing Floors –Alternative Outcome Transactions *(cont'd)***

- Notwithstanding, the issuance of convertible securities with “sweeteners” or “penalties” may comply with the Nasdaq rules, provided that no common shares are issuable prior to the shareholder vote
- Following a negative vote the securities may convert into up to 19.9% or the pre-transaction tso; however, additional votes to remove the cap would not be permitted pursuant to the alternative outcome policy
- In the case of a floating rate convertible security, Nasdaq may require a floor in the conversion price even if the transaction will be shareholder approved – generally, a conversion floor that is 20% of the market price on the date of the definitive agreement will be sufficient

# Aggregation of Offerings

- For purposes of the 20% rule, Nasdaq will consider the following factors:
  - Timing of the issuances (no safe harbor for transactions more than six months apart; however, in the absence of other linkage factors, generally transactions that are 6 months or more apart will not be aggregated)
  - Commonality of investors
  - Existence of contingencies between the transactions (*e.g.*, rights of first refusal or participation)

## Aggregation of Offerings *(cont'd)*

- Similarities between deal structures
- Commonalities as to use of proceeds
- Timing of the board of directors' approvals
- **Note:** Nasdaq will generally not aggregate a shareholder approved transaction or a public offering with a transaction that requires shareholder approval
- **Note:** If Nasdaq believes the transactions are part of a “single plan of financing” they are likely to aggregate

# Public Offerings Are Exempt from the Shareholder Approval Requirement; Factors Considered in Determining whether an Offering Is Deemed “Public”

- Nasdaq shareholder approval requirements do not apply to “public offerings” under Nasdaq rules.
- Nasdaq will not treat an offering as a "public offering" for purposes of the shareholder approval rules merely because the securities offered are registered with the SEC prior to the closing of the transaction.
- Generally, a firm commitment underwritten securities offering registered with the SEC will be considered a public offering for these purposes because of the economics of price discovery attendant to the underwriter’s book building process and shareholders’ ability to participate in the offering.
- Nasdaq will consider all relevant factors when determining whether an offering is a "public offering" for purposes of these rules (See IM-5635-3).

## Public Offerings *(cont'd)*

- The type of offering (including whether the offering is conducted by an underwriter on a firm commitment basis, or an underwriter or placement agent on a best-efforts basis, or whether the offering is self-directed by the company);
- The manner in which the offering is marketed (including the number of investors offered securities, how those investors were chosen, and the breadth of the marketing effort);
- The extent of the offering's distribution (including the number and identity of the investors who participate in the offering and whether any prior relationship existed between the Company and those investors);
- The offering price (including the extent of any discount to the market price of the securities offered – discounts in excess of 50% are not permitted);
- The extent to which the Company controls the offering and its distribution.

## Public Offerings (*cont'd*)

- Nasdaq will also consider:
  - Whether the offering was announced to the public before it was priced
  - Whether the offering was marketed to retail investors
    - Offerings of securities not available to retail investors (*i.e.*, 144A offerings of convertible notes) are not public offerings under Nasdaq rules.
  - The portion of the offering allocated to the largest purchaser
    - If the vast majority of the securities offered were allocated to one investor (or group of affiliated investors) it is more likely that the offering price was derived through the direct negotiation with the investor rather than through the economics of price discovery attendant to the underwriter's book building process.

# Registered Directs (RD), Confidentially Marketed Public Offerings (CMPO), At-The-Market (ATM) offerings

- Transaction's status as a RD, CMPO or an ATM does not, in and of itself, dictate whether it is a public offering under Nasdaq rules.
- Factors described in previous slides apply.
- RD, typically, is not a public offering because companies usually negotiate the transaction and issue the securities directly to the investors.
- CMPO could be a public offering. See Interpretation Letter 2009-13.
- ATM, generally, is a public offering. See Interpretation Letter 2007-22.
  - Many ATM offerings contain a provision that the sales agent may act as a principal or sell shares in privately negotiated transactions instead of into the existing trading market.
  - Unless such provision is limited, an ATM may not be a public offering under Nasdaq rules.

# Treatment of Warrants in a Public Offering

- If the offering discount exceeds 50%, Nasdaq will generally not consider the offering to be a “public offering”
- For purposes of calculating the offering discount, Nasdaq will ascribe a value of \$0.125 per warrant
- As a result, a company with a \$0.25 share price that is completing an offering with common stock and 100% warrant coverage cannot sell a unit for less than \$0.25 per share
- Warrants that are exchangeable for common stock if the common stock does not trade at a certain price after a set period of time may be factored into the discount.

# Equity Compensation

- Pursuant to Listing Rule 5635(c), shareholder approval is required for the issuance of common stock or securities convertible into or exercisable for common stock at a price less than the “consolidated closing bid price” (**Note:** this is different from the NOCP) unless the issuance is part of a public offering (as described in IM-5635-3)
- Issuances to an entity controlled by an officer, director, employee or consultant may also be considered equity compensation under certain circumstances, such as where the issuance would be accounted for under Generally Accepted Accounting Principles as equity compensation or result in disclosure of compensation under applicable provisions of Regulation S-K

# Financial Viability Exception

- The rules provide for an exception to the applicability of the shareholder approval and voting rights rules where the delay in securing stockholder approval would seriously jeopardize the financial viability of the company (and certain other procedural requirements are met).
- To request a financial viability exception, the company must submit a formal rule interpretation request.
- Reliance on a financial viability exception must expressly be approved by the audit committee.
- A company that receives a financial viability exception must mail to all shareholders (no later than ten calendar days before issuance of the securities) a letter alerting them to its omission to seek the shareholder approval that would otherwise be required.

# NYSE Rules

# NYSE Rule 312

- Rule 312.03(c) requires shareholder approval prior to the issuance of common stock, or securities convertible into or exercisable for common stock, if:
  - The common stock has, or will have upon issuance, voting power equal to or in excess of 20% of the voting power outstanding before the issuance of such stock; or
  - The number of shares of common stock to be issued is, or will be upon issuance, equal to or in excess of 20% of the number of shares of common stock outstanding before the transaction
- “Voting power outstanding” 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 securityholders for a vote

## NYSE Rule 312 *(cont'd)*

- Shareholder approval will not be required in connection with:
  - Any public offering for cash, or
  - Any issuance involving a “bona fide private financing,” if such private financing involves a sale of:
    - Common stock, for cash, at a price at least as great as the market value of the issuer’s common stock; or
    - Securities convertible into or, exercisable for common stock, for cash, if the conversion or exercise price is at least as great as market value of the issuer’s stock (a so-called “above market” transaction)

## NYSE Rule 312 *(cont'd)*

- A “bona fide private financing” is a sale in which either:
  - A registered broker-dealer purchases securities from the issuer with a view to the private sale of such securities to one or more purchasers; or
  - The issuer sells the securities to multiple purchasers, and no one such purchaser, or group of related purchasers, acquires or has the right to acquire upon exercise or conversion of the securities, more than 5% of the shares of the issuer’s common stock or more than 5% of the issuer’s voting power before the sale
- Traditional Rule 144A offerings generally will meet the “bona fide private financing” definition

# NYSE Amendment

- On October 31, 2018, the NYSE filed a proposed amendment to the Listed Company Manual to modify the price requirements for purposes of determining whether shareholder approval is required for certain issuances of securities.
- The new NYSE rule replaces the “market value” test with a new definition known as “Minimum Price.”
- The Minimum Price is defined as the lower of (i) the closing price of the issuer’s common stock immediately before the execution of the transaction agreement and (ii) the average closing price of the issuer’s common stock during the five days immediately preceding the transaction agreement.
- Shareholder approval is required for transactions that are priced below the Minimum Price.

## NYSE Amendment *(cont'd)*

- The NYSE amendment eliminates the requirement for shareholder approval of issuances at a price less than book value but greater than market value.
- Aligns with Nasdaq's 2018 amendments that eliminate "book value" in the determination of whether shareholder approval is needed.
- On March 20, 2019, the SEC approved the NYSE's amendment.

# NYSE Related Party Rule

- Shareholder approval is required prior to the issuance of common stock (or securities convertible into or exercisable for common stock), to certain Related Parties to the extent that the number of shares of common stock to be issued, or the number of shares of common stock into which the securities may be convertible or exercisable, exceeds 1% of either the number of shares of common stock or the voting power outstanding before the issuance (or 5% of either the number of shares of common stock or the voting power outstanding if the Related Party is only a significant shareholder).
- Related Parties include a director, officer or significant shareholder of the issuer, a subsidiary, affiliate or other closely-related person of a Related Party, or any company or entity in which a Related Party has a substantial direct or indirect interest

## NYSE Related Party Rule *(cont'd)*

- An exemption was adopted for “early stage companies” to issue shares of common stock (or exchangeable or convertible securities) without shareholder approval to a Related Party under certain conditions
- “Early stage company” is a company that has not reported revenues in excess of \$20 million in any two consecutive fiscal years since its incorporation
- The audit committee must review and approve the transaction prior to completion. This exemption is only available for sales of securities for cash and is not available for issuances in connection with an acquisition transaction