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## SEC'S NEW INTERPRETATION OF RULE 415 SEVERELY LIMITS USE OF PIPES

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Private Investment in Public Equity (“PIPE”) transactions are private placements of equity securities or convertible debt securities by public companies generally made to accredited investors, followed by the prompt filing with the U.S. Securities and Exchange Commission (the “SEC”) of a registration statement to cover the resale of those securities. PIPEs represent an attractive means for a company to raise money quickly because the SEC review, if any, occurs after the sale of securities. Accordingly, these types of transactions have become increasingly popular with small and mid-cap companies over the last few years.

Two characteristics of recent PIPE transactions, namely the large number of shares being registered in relation to the number of shares outstanding (referred to by the Staff as “extreme convertibles”) and the nature of the resellers as active market participants, have caused the SEC staff (“Staff”) growing concern that PIPE transactions are actually primary offerings by the issuer, rather than secondary offerings by the selling shareholders. Consequently, in recent months the Staff has taken a new position with respect to PIPE transactions. Specifically, the Staff is now questioning whether the offering is a primary offering if (i) the securities issued in a private placement and registered by a company for resale (including all shares

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underlying any convertible security, any option, any warrant and any equity line) exceed thirty-three percent (33%) of the public float<sup>1</sup> of the issuer and (ii) the resale registration is not filed on Form S-3 pursuant to Rule 415 of the Securities Act of 1933.

Pursuant to Rule 415, a resale offering is permitted to be registered as a shelf registration (i.e., on a continuous or delayed basis) regardless of the form. A primary offering, however, may only be registered as a shelf registration if it is eligible as a primary offering on Form S-3, and Form S-3 may be used only where the issuer has a public float of at least \$75 million.<sup>2</sup> Few extreme convertible transactions will satisfy this public float requirement. Thus, the Staff's new position has the effect of prohibiting the registration of the resale of the securities issued in many PIPEs because the transactions will be deemed primary offerings, but will be unable to meet the Rule 415 eligibility requirements to register on Form S-3.

If a company attempts to register for resale thirty-three percent (33%) or greater of the total amount of the company's public float, the Staff will implement its new interpretation of Rule 415 by issuing a comment that asks whether the transaction should be characterized as a primary offering and be on a form that the company is eligible to use for a primary offering. If the company responds with an argument that the offering is not a primary offering, the matter will be addressed by an Associate Director at the SEC for a determination. Examples of factors that could be used by a registrant in justifying that the offering is not a primary offering include: (i) the number of the selling security holders and the extent of any control blocks being offered to the public (the thinking being that the absence of large selling shareholders will ease the Staff's concerns); (ii) extended holding periods of affiliates; (iii) in the case of a reverse acquisition accompanied by a financing, the argument that the affiliate position should be included in the float if the affiliate is not proposing to be a seller in the offering; (iii) inclusion in the public float of any securities that are being registered for an acquisition provided that the acquisition is accretive to the enterprise value of the company; and (iv) inclusion of the common stock equivalent of an outstanding convertible security in the public float if the security is immediately convertible into common stock without the payment of any further consideration.

The SEC Staff has stated informally that it will begin to require more detailed disclosure in PIPE resale registration statements that is intended to highlight the risks involved in the purchase of the securities and the potential for material and immediate market risk. The current thinking of the Staff is that the disclosure would include: (i) the overall cost to the issuer of the financing transaction including options, warrants, derivative securities and fees paid to the PIPE investors or their affiliates (though it is unclear how

<sup>1</sup>Public float is generally defined as the total outstanding capital stock less shares held by affiliates.

<sup>2</sup>See Rule 415(a)(1)(x) of the Securities Act of 1933, as amended.



those costs would be presented); (ii) the impact of potential dilution resulting from the PIPE transaction, as well as potential dilution that may occur in connection with the future resale of the securities that underlie the PIPE investment made; and (iii) the identity of the control persons of the PIPE investors that have significant ownership positions and any affiliation among those investors. The Staff's review will be far more critical where there is extensive warrant coverage, significant penalties, price protection and/or ratchet anti-dilution protection as well as circumstances in which the selling security holders are control persons.

In the past, PIPEs have represented one of only a few viable alternatives for smaller public companies in need of immediate funding. The Staff's new interpretation of Rule 415(a)(1)(iv) is likely to have a chilling effect on such companies' ability to raise capital going forward and consequently, may result in the failure of many small issuers.

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