MORRISON FOERSTER

FREQUENTLY ASKED QUESTIONS ABOUT THE 20% RULE AND NON-REGISTERED SECURITIES OFFERINGS

Understanding the 20% Rule

What is the 20% rule?

The "20% rule," as it is often referred to, is a corporate governance requirement applicable to companies listed on Nasdaq, the NYSE or the NYSE American LLC ("NYSE American") (collectively, the "Exchanges"). Each Exchange has specific requirements applicable to listed companies to receive shareholder approval before they can issue 20% or more of their outstanding common stock or voting power in a "private offering." The Exchanges also require shareholder approval in connection with certain other transactions. Generally:

- Nasdaq Rule 5635(d) requires shareholder approval for transactions, other than "public offerings," involving (1) the sale, issuance or potential issuance by an issuer of 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 of the issuer, equals 20% or more of the shares of common stock or 20% or more of the voting power outstanding before the issuance, or (2) the sale, issuance or potential issuance by the issuer of common stock (or securities convertible into or exercisable for common stock) equal to 20% or more of the shares of common stock or 20% or more of the voting power outstanding before the issuance at a price less than the greater of book or market value of the common stock.
- NYSE American section 713(a) contains a rule almost identical to the Nasdaq rule.
- NYSE Rule 312.03(c) requires shareholder approval prior to the issuance of common stock, or securities convertible into or exercisable for common stock, if (1) the common stock has, or will have upon issuance, equals or exceeds 20% of the voting power outstanding before the issuance of such stock; or (2) the number of shares of common stock to be issued is, or will be upon issuance, equal to or in excess of 20% 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.

However, under NYSE Rule 312.03(c), the situations in which shareholder approval will not be required include: (1) any public offering for cash, or (2) any issuance involving a "bona fide private financing,[1]" if such private financing involves a sale of: (a) common stock, for cash, at a price at least as great as each of the book and market value of the issuer's common stock; or (b) securities convertible into or exercisable for common stock, for cash, if the conversion or exercise price is at least as great as each of the book and market value of the issuer's stock (a so-called "above market" transaction).

What is the purpose of the 20% rule?

Follow-on offerings of equity securities of an issuer are potentially dilutive to the issuer's existing shareholders and offerings of 20% or more of an issuer's equity securities at a price below book or market value might be significantly dilutive. Further, due to the private

1 NYSE Rule 312.04(g) defines "bona fide private financing" as a sale in which either: (i) 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 (ii) 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.

nature of these offerings, an issuer's existing smaller shareholders typically cannot participate. Thus, the purpose of the 20% rule is to provide shareholders with adequate notice and disclosure of the proposed offering so that they might have an opportunity to sell their shares or vote on the proposed offering.

What are the consequences of violating the 20% rule?

Companies that do not comply with the 20% rule may face delisting by the relevant Exchange[2]. Accordingly, listed companies must carefully plan transactions that may be subject to the 20% rule.

What types of transactions trigger the 20% rule?

The 20% rule applies to any non-public transaction and certain public transactions, including shares issued in connection with acquisitions (in the case of an NYSE-listed company) and issuances of equity securities or securities exercisable for equity securities.

How does the 20% rule relate to the rules governing transactions involving a "change in control" or an acquisition?

Change of Control

Both Nasdaq and the NYSE American require an issuer to obtain shareholder approval prior to an issuance of securities that will result in a "change of control." Nasdaq requires issuers to notify Nasdaq at least 15 calendar days before issuing securities that may potentially result in a change of control. The NYSE American simply cautions that an issuer considering issuing "a significant percentage" of its shares should consult the exchange to determine whether shareholder approval is required.

While neither Nasdaq nor the NYSE American has formally defined "change of control," Nasdaq has provided some guidance. Nasdaq will consider several factors in determining whether a change of control will occur as a result of a transaction, the most salient of which are the post-transaction stock ownership and voting rights of the investors. This "change of control" test can be somewhat subjective. Generally, if a transaction results in an investor or group of investors obtaining a 20% interest or a right to acquire that interest in the issuer on a post-transaction basis, and that ownership position would be the largest position in the issuer, the transaction may be presumed to be a change of control and should be carefully reviewed. Needless to say, this threshold is less than the "51% or greater" ownership that might suggest "control" to many; accordingly, practitioners should make the parties to a transaction aware of these issues as early as possible. However, if pre-existing control positions are not displaced by the transaction (for example, if another shareholder has a more significant ownership interest), Nasdaq may determine that shareholder approval is not required with respect to the transaction (although it may be required for other reasons, including the 20% rule).[3]

The NYSE has a similar rule that shareholder approval is required prior to an issuance that will result in a "change of control." The NYSE also does not define change of control, and the exchange applies a subjective test on a case-by-case basis. Generally, purchases of more than 30% of the outstanding voting stock are presumed to constitute a change of control, and purchases of between 20% and 30% of the outstanding voting stock may be presumed to constitute a change of control, depending on the NYSE's review of the issuer's corporate governance structure, such as board seats, management rights and other control rights of the acquirer of the securities. Although the NYSE has allowed certain transactions to proceed without a shareholder vote under both the 20% rule and the change of control rule, under this subjective NYSE test, an issuance of even less than 20% of common stock or voting power may be sufficient in some situations to be deemed to have resulted in a change of control. Issuers should seek specific guidance from the NYSE before proceeding with a transaction.

Acquisitions

Nasdaq issuers must also keep in mind that an acquisition-related issuance of securities may fall under the "acquisition rule" rather than the 20% rule, if the issuance is equal to or greater than 20% of the number of shares of common stock or voting power outstanding, or if insiders have an interest in the target entity, 5% of the number of shares of common stock or voting power outstanding. Nasdaq will use the following factors to determine which rule to apply:

- proximity of the financing to the acquisition;
- timing of board approvals;
- stated contingencies in the acquisition documents; and
- stated uses of proceeds.[4]

2 *See* Nasdaq Rule 5801, NYSE Rule 801.00, and NYSE American section 1002.

3 *See, e.g.,* Nasdaq Staff Interpretative Letters 2007-25, 2008-3 and 2008-5.

4 For more information on the Nasdaq acquisition rule, see Nasdaq FAQs, Shareholder Approval—Acquisitions.

The NYSE American has a similar rule that shareholder approval is required for securities issued as sole or partial consideration for an acquisition of the stock or assets of another company if the issuance is equal to or greater than 20% of the number of shares of common stock or voting power outstanding, or if insiders have an interest in the target entity, 5% of the number of shares of common stock or voting power outstanding. The NYSE American also notes that a series of closely related transactions may be regarded as one transaction for the purpose of the acquisition rule. Issuers should seek specific guidance from the NYSE before proceeding with an acquisition-related issuance.

It is prudent to consider the change of control rule, the acquisition rule and the 20% rule in any transaction that involves an issuance close to 20%. In many cases, it will be appropriate to consult the relevant Exchange early in the transaction process.

When do issuances to officers, directors, significant shareholders and other related parties require a shareholder vote?

Under the NYSE rules, shareholder approval is required prior to the issuance of common stock, or securities convertible into or exercisable for common stock, in any transaction to a director, officer or significant shareholder of the issuer (a "Related Party"), 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, if 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).

However, there is a new exemption from this rule under some circumstances for smaller companies. In December 2015, the NYSE amended section 312.03(b) of its Listed Company Manual to permit "early stage companies" to issue shares of common stock (or exchangeable or convertible securities) without shareholder approval to a related party, 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. An "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; and a "related party" is defined as a director, officer or holder of 5% or more of the issuer's common stock. In order to use the exemption, the audit committee (or a similar committee of independent directors) of the issuer 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.

In contrast to the NYSE, Nasdaq and the NYSE American do not have an analogous rule and do not require shareholder approval for issuances to Related Parties unless one of the other rules discussed herein is implicated. However, Nasdaq might view an issuance to an employee, officer or director priced at a discount as equity compensation under Nasdaq Rule 5635(c), thus requiring shareholder approval.

Where can the relevant rules and additional resources as to their interpretation be located?

The relevant Nasdaq rules can be found at: http://goo.gl/8HGGfe. Nasdaq also maintains searchable (a) FAQs available at: https://goo.gl/gzySjE and (b) staff interpretation letters available at: https://goo.gl/6FtgV6.

The relevant NYSE rules can be found at: http://goo.gl/r2JKrZ.

The relevant NYSE American rules can be found at: http://goo.gl/6Znn10.

The "Public Offering" Exception and Analyzing Different Types of Offerings Under the 20% Rule

What is the "public offering" exception to the 20% rule?

Under Nasdaq and NYSE American rules, shareholder approval is not required for a "public offering."[5] Under each Exchange's rules, an offering is not deemed to be a "public offering" merely because it is made pursuant to a registration statement, but a firm commitment underwritten offering, registered with the Securities and Exchange Commission (the "SEC"), will be considered a public offering. The Nasdaq and NYSE American staffs will consider all relevant factors when determining whether an offering qualifies for the public offering exemption, including:

- the type of offering, including (1) whether the offering is conducted by an underwriter on a firm commitment basis, (2) whether the offering is conducted by an underwriter or placement agent on

5 *See* Nasdaq Rule 5635(d) and NYSE American section 713.

a best efforts basis, or (3) whether the offering is self-directed by the issuer;

- the manner in which the offering is marketed;
- the extent of the offering's distribution, including the number of investors who participate in the offering;
- the offering price; and
- the extent to which the issuer (as opposed to, for example, a third-party underwriter) controls the offering and its distribution.[6]

Issuers are encouraged to seek the relevant Exchange staff's advice to determine whether or not a particular offering is a public offering for purposes of the 20% rule.

The NYSE similarly exempts "public offerings for cash" from the 20% rule,[7] but does not offer formal guidance to determine when a particular offering would qualify as a public offering. However, the NYSE will generally consider firm commitment underwritten offerings to be "public offerings."

Issuers seeking to ensure that an offering meets the public offering exemption should plan to market the offering broadly, including to both retail and institutional investors.

How are hybrid offerings, such as registered direct offerings, analyzed under the 20% rule?

The mere fact that the offering is registered with the SEC does not necessarily make the offering "public" for Exchange purposes. Although a registered direct transaction by definition is a public offering for SEC purposes, in certain circumstances such transaction may be considered by the Exchanges to be a private placement and, accordingly, subject to the 20% rule. For example, Nasdaq's unwritten policy is to consider whether the offering was marketed widely to retail investors. Nasdaq will consider the particular circumstances of the transaction, such as the number of offerees and the manner in which the offering was marketed. Additionally, Nasdaq expects the issuer to issue a press release announcing the offering in advance of the completion of the marketing effort.

As discussed above, the NYSE does not offer formal guidance to determine when a particular offering would qualify as a public offering.

When conducting a narrowly marketed hybrid offering, issuers might obtain shareholder approval prior to commencing the offering, limit the size of the offering to 19.99% of the issuer's common stock outstanding prior to the offering, or ensure pricing at or above market.

Does the 20% rule raise any concerns in the context of a confidentially marketed public offering?

Confidentially marketed public offerings ("CMPOs") will typically not be affected by the 20% rule. Unlike hybrid offerings, CMPOs are firm commitment underwritten offerings; thus the Exchanges will consider CMPOs "public offerings." Additionally, in a CMPO, the issuer will typically issue a press release announcing the offering at 4:01 p.m. on the last day of confidential pre-marketing, at which point the offering becomes public and retail investors can participate. This further satisfies the "public offering" requirement.

How are Rule 144A offerings analyzed under the 20% rule?

Offerings under Rule 144A ("Rule 144A") under the Securities Act of 1933, as amended (the "Securities Act"), are not by definition "public offerings" despite the fact that they generally share many of the characteristics of a public offering, including a firm commitment obligation of the initial purchasers to purchase the securities. Additionally, the "non-fungibility" provisions of Rule 144A prohibit the issuance of equity securities pursuant to Rule 144A that are substantially similar to a class of securities listed on a national securities exchange or quoted in an automated inter-dealer quotation system. These attributes of Rule 144A offerings have led a number of market participants and their counsel to suggest to Nasdaq that Rule 144A offerings be considered "public offerings" for purposes of the 20% rule. At this time, Nasdaq has not indicated whether it will propose such a change to its rules. In contrast, Rule 144A offerings fall under the "bona fide private financing" exemption under NYSE Rule 312.04(g).

For securities convertible or exchangeable for a listed security, the Rule 144A non-fungibility provision is satisfied if the securities have a conversion premium of at least 10%. Such a conversion premium would theoretically satisfy the Exchanges' concerns about excessive dilution without the approval of shareholders. Offerings under Rule 144A for securities convertible or exchangeable for a listed security typically also have a "blocker" provision in the document describing the rights of the securityholder (*i.e.*, the indenture for convertible debt securities or the certificate of designations for convertible preferred stock). A blocker provision serves to prevent violations

6 *See* Nasdaq IM 5635-3 and Commentary to NYSE American section 713.

7 *See* NYSE Rule 312.03(c).

of the 20% rule incident to conversions of the securities, the impact of a fundamental change clause or the effect of a make-whole provision satisfied in stock.[8]

How are "net share settled" convertible bonds treated for purposes of the 20% rule?

Net share settled convertible bonds allow for the payment to the investor to be made in shares, cash or a combination of both. An issuer that is concerned about the dilutive effect of settling in stock may elect to pay a portion of the conversion value in cash rather than in shares. Previously, both Nasdaq and the NYSE considered issuances of this type of convertible bond to be ineligible for the exemption from shareholder approval. However, in March 2015, Nasdaq indicated that convertible bonds with flexible settlement provisions will be treated the same way as physically-settled bonds under the rule. If the conversion price of the bonds equals or exceeds the greater of the book value and market value per share of the issuer's common stock, shareholder approval will not be required.[9]

Market Value, Calculating the 20% Limit and the Treatment of Warrants

How is "less than market value" determined?

Nasdaq defines "market value" as the consolidated closing bid price immediately preceding the time at which the parties enter into the agreement to issue the securities. If a transaction is entered into during market hours before the close of the regular session at 4:00 p.m., EST, the closing bid from the previous day's trading will be used. If the transaction is entered into after the close of the regular session, then that day's closing bid price is used.

The NYSE defines "market value" as the official closing price on the NYSE as reported to the consolidated tape immediately preceding the time at which the parties enter into a binding agreement to issue the securities.

The NYSE American rules do not include a definition of market value.

The Exchanges will not consider an average price over two or more trading days or a volume weighted average price (VWAP) in determining market price. Therefore, the timing of the signing of a definitive purchase agreement may be meaningful if the issuer's stock price is volatile.

For Nasdaq purposes, "book value" is the shareholders' equity from the issuer's most recent public filing with the SEC. The shareholders' equity divided by the total shares outstanding is the book value per share. Goodwill and other intangible assets are included in an issuer's book value. Also, a more recent book value may be used if an issuer files a document with the SEC, such as a Current Report on Form 8-K or Report on Form 6-K, reflecting the shareholders' equity and shares outstanding to allow for the calculation of an updated book value. The NYSE and NYSE American rules do not include a definition of book value.

How is the market value of convertible securities determined?

For Nasdaq issuers, securities convertible into or exercisable for common stock are issued at a discount to market value if the conversion or exercise price is less than the market value of the common stock at the time the parties enter into a binding agreement with respect to the issuance. The NYSE and NYSE American have applied a similar formulation in specific transactions, but have not issued formal guidance on this point.

How is the 20% limit calculated?

Under the Nasdaq and NYSE American rules, the percentage of common stock to be issued in a transaction is calculated by dividing the "maximum potential issuance" by the number of shares of common stock issued and outstanding before the transaction. The "maximum potential issuance" will include all securities initially issued or potentially issuable or potentially exercisable or convertible into shares of common stock as a result of the transaction, including as a result of earn-out clauses, penalty provisions and equity compensation awards. The number of shares of common stock issued and outstanding before the transaction will include all classes of common stock added together and should not assume the conversion or exercise of any options, warrants or other convertible securities. Accordingly, the test is "biased" in favor of calculating a higher percentage.

Under the NYSE rules, the calculation depends on voting power: the 20% limit is based on the voting power of the common stock, or securities convertible into common stock, to be issued divided by the "voting power outstanding" before the issuance. "Voting power outstanding" refers to the aggregate number of votes that may be cast by holders of those securities

8 For more information on Rule 144A, *see* our "Frequently Asked Questions About Rule 144A." available at: http://www.mofo.com/files/Uploads/Images/FAQRule144A.pdf.

9 See Nasdaq FAQ 1136.

outstanding that entitle the holders to vote generally on all matters submitted to the issuer's securityholders for a vote.

The Exchanges will each aggregate sales by officers, directors and substantial shareholders with shares issued by an issuer in calculating the 20% limit.

How are warrants treated for purposes of the 20% rule?

The inclusion of warrants in a private placement or registered direct offering will affect the analysis of the market value of the securities offered. For Nasdaq issuers, if the common stock portion of an issuance that includes warrants is less than the 20% threshold and the shares of common stock are offered at a price below the greater of market or book value, but with the inclusion of the warrant portion (assuming full exercise) the offering results in an issuance of shares of common stock that is greater than 20% of the pre-transaction shares outstanding, then the transaction will require shareholder approval. However, the warrant portion will be excluded from the 20% rule analysis if the warrant exercise price is at or above the greater of market or book value and the warrants are not exercisable for at least six months.

If the common stock portion of an offering that includes warrants exceeds the 20% threshold, Nasdaq will value the warrants at $0.125 (plus any amount by which the warrant is in the money), regardless of whether the exercise price exceeds the market value.[10] This is often referred to as the "1/8th Test." Therefore, a Nasdaq issuer issuing units with 100% warrant coverage should price the units at least $0.125 above the greater of market or book value of the common stock or else seek shareholder approval prior to the transaction. Even if the warrants have a six-month exercise period, they will still be included in the calculation.

The NYSE and NYSE American do not provide formal guidance on the valuation of warrants for purposes of the 20% rule. The NYSE has, however, given informal guidance indicating that it will accept a valuation based on Nasdaq's 1/8th Test.

10 For example, if an issuer's common stock has a market value of $10 per share and the issuer issues units consisting of one share of common stock and one warrant (thus reflecting 100% warrant coverage) exercisable at $10 per share, unless the price of the units in the offering is at least $10.125, Nasdaq will consider the offering to be issued at a discount, regardless of whether the warrants are immediately exercisable.

How are transactions that include "penny warrants" treated for purposes of the 20% rule?

Nasdaq has indicated that it closely examines any offering that includes warrants that are exercisable for little or no consideration, referred to as "penny warrants," as such a transaction may be dilutive to shareholders and provide little economic benefit to the issuer. Nasdaq may exercise its discretionary authority to object to a transaction involving penny warrants, even when shareholder approval is not required. Issuers considering a transaction involving penny warrants or other deeply discounted securities should consult Nasdaq before moving forward.[11]

The NYSE and NYSE American do not provide guidance on the evaluation of penny warrants.

How are warrants with a cashless exercise feature treated under the 20% rule?

In February 2017, Nasdaq indicated that, although its rules do not explicitly prohibit the issuance of warrants with a cashless exercise feature (i.e., warrants that allow the holder, under certain circumstances, to exercise or exchange them for stock in a cashless transaction), they could still result in the issuance of an increasing number of shares as the issuer's share price declines. Depending on the circumstances, Nasdaq can determine that the issuance of these types of warrants raises public interest concerns.

When reviewing transactions that include these types of warrants, Nasdaq generally assumes that the conversion of the warrants will result in the maximum possible dilution over the shortest period of time. In addition, in determining whether the issuance of these types of warrants raise public interest concerns, Nasdaq will consider the following factors:

- the business purposes of the transaction;
- the amount to be raised in the transaction relative to the issuer's existing capital structure;
- the dilutive effect of the transaction on the existing shareholders;
- the risk undertaken by the investors in the new securities;
- the relationship between the investors and the issuer;

11 *See* Nasdaq FAQs, Shareholder Approval—Private Placements, available at: https://listingcenter.Nasdaqomx.com/MaterialHome.aspx?mcd=LQ. For information regarding penny warrants, see our "Practice Pointers: Pre-Funded Warrants," available at: https://media2.mofo.com/documents/170927-practice-pointers-pre-funded-warrants.pdf.

- whether the transaction was preceded by other similar transactions;
- whether the transaction is consistent with the just and equitable principles of trade; and
- whether the warrant includes features to limit the potential dilutive effect of its conversion or exercise.

Issuers considering a transaction involving warrants with a cashless exercise feature should consult Nasdaq before moving forward.

Two-Step Transactions and Share Caps

How are two-step transactions used to comply with the 20% rule?

The amount of time required to obtain shareholder approval of a transaction, including preparation and possible SEC review of the proxy statement and the notice period required by state law, is typically prohibitive for most substantial private placements. Furthermore, the issuer may have an immediate need for cash. Private placements may be expedited by structuring the transaction in two steps (or tranches). An issuer may issue:

- up to 19.9% of the outstanding common stock (or securities convertible into or exercisable for common stock) prior to receiving shareholder approval; and
- an additional amount if and when shareholder approval is obtained (such vote to be scheduled after the closing of the first tranche).

How are share caps evaluated by the Exchanges?

Nasdaq guidance specifically indicates that "share caps" (i.e., provisions prohibiting the issuance of securities in excess of 19.9% of the pre-transaction total shares outstanding) and "floors" on the conversion price of convertible securities are acceptable mechanisms to avoid the need to obtain shareholder approval prior to the completion of a transaction. However, Nasdaq will not accept a share cap if the shares that are issuable under the cap (in the first part of the transaction) are entitled to vote to approve the second step of the transaction. Similarly, securities that are convertible for common stock are not entitled to convert prior to the shareholder vote; and if shareholders disapprove the transaction, then conversions can take place up to but not reaching an amount that would require shareholder approval. In addition, a cap must apply for the life of the security or until shareholder approval is obtained. Nasdaq will also not accept a cap that is only in place while an issuer is listed on Nasdaq.[12]

The NYSE American has provided similar guidance indicating that share caps may be employed as a way to avoid the need for shareholder approval prior to the completion of a transaction, although the use of share caps cannot be coercive.[13]

The NYSE has not provided formal guidance on two-step transactions, but it has accepted such transactions on several occasions, although the use of a share cap cannot be coercive.[14]

What are "alternative outcomes" in the context of two-step transactions?

In accordance with Nasdaq guidance, share caps may not be used in connection with the issuance of convertible securities that include a "penalty" or "sweetener" triggered upon the outcome of the shareholder vote (referred to by Nasdaq as "alternative outcome transactions"). Penalties and sweeteners are terms of convertible instruments (such as an increased coupon or conversion ratio or a monetary fee to the issuer) that are triggered if shareholders reject a portion of the transaction. An example of an impermissible share cap would be an issue of convertible preferred stock or debt that provides for conversions of up to 19.9% of the total shares outstanding, with any further conversions subject to shareholder approval, if the terms of the convertible preferred stock or debt contain a penalty or sweetener.[15] Impermissible sweeteners might also be structured to benefit the existing shareholders, for instance, if the interest rate on a convertible note starts at 20%, but decreases to 5% if the shareholders approve the second step of a two-step transaction.

Other examples of alternative outcomes include changes to the interest and/or dividend rates, rights of rescission where funds are returned to an investor if shareholder approval is not obtained, changes to maturity dates, and changes to investment amounts, even if these changes may benefit the issuer.[16] Although the NYSE and NYSE American do not provide the robust guidance that Nasdaq provides on alternative outcomes, issuers should consult with the relevant Exchange before setting the final terms of a transaction as the Exchanges will provide informal guidance on the features they deem coercive.

12 *See* Nasdaq IM 5635-2

13 *See* Commentary to NYSE American section 101.

14 *See, e.g.*, Current Reports on Form 8-K filed by CAMAC Energy Inc. on January 6, 2012, and by Cal Dive International, Inc. on July 18, 2012.

15 *See* Nasdaq IM 5635-2 and Nasdaq FAQs, Shareholder Approval—Alternative Outcomes & Defective Share Caps.

16 *See* Nasdaq Staff Interpretative Letter 2009-15.

Under what circumstances will offerings be "aggregated" for the purposes of the 20% rule?

Nasdaq will consider the following factors in determining whether multiple issuances should be aggregated for the purposes of the 20% rule:

- the timing of the issuances;
- the facts surrounding the initiation of the subsequent transaction (i.e., if the issuer is already planning the subsequent transaction at the time of the first transaction, or if the issuer already expected that it would need to raise additional capital);
- the commonality of investors;
- the existence of contingencies between the transactions;
- any commonalities as to use of proceeds; and
- timing of board approvals.[17]

The more links that exist between the issuances, the more likely it is that Nasdaq will aggregate the issuances. If the aggregated issuances breach the 20% threshold, shareholder approval will be required. These considerations are similar, though not identical, to the five-factor integration test under Rule 502(a) of Regulation D under the Securities Act ("Regulation D"). The five-factor test is used to analyze whether two or more private offerings should be integrated for the purposes of determining whether an issuance meets the requirements under Regulation D for exemption from registration. For example, Nasdaq generally does not aggregate transactions that are more than six months apart. The NYSE and NYSE American, however, do not provide precise guidance as to when multiple issuances will be aggregated.

Other Exceptions to the 20% Rule

Are foreign private issuers subject to the 20% rule?

Both Nasdaq and the NYSE American generally allow foreign private issuers ("FPIs") to follow the practices of their country of domicile, including those practices relating to shareholder approval rules. This typically acts as an exemption to the 20% rule for FPIs. In order to avail itself of this exemption, an FPI must:

- notify the Exchange of its intent not to follow the Exchange's shareholder approval rules;
- provide an opinion of local counsel in its country of domicile that the FPI's practice does not violate the laws of its country of domicile; and
- disclose the practice in its Annual Report on Form 20-F.

The NYSE exempts FPIs from the 20% rule entirely and does not require that any additional actions be taken by an FPI in order to take advantage of the exemption.

What is the "financial viability" exception to the 20% rule?

For issuers with a need to access the capital markets immediately and when the viability of the business is in danger, the 20% rule is an obstacle that may force an issuer either to seek less capital than it needs or to structure the transaction as a two-step transaction (discussed above). In situations where waiting for shareholder approval could result in the issuer's financial demise, another option is to seek a "financial viability" exception. Upon application to the relevant Exchange, an exception to the shareholder approval requirement for a specified issuance of securities may be made if it meets two requirements:

- the delay in securing shareholder approval would "seriously jeopardize the financial viability" of the issuer; and
- reliance on the exception is expressly approved by the audit committee or comparable body of the board of directors of the issuer.[18]

In order to avail itself of this exception, an issuer must show that a delay in completing a proposed transaction in order to obtain shareholder approval would "seriously jeopardize the financial viability" of the issuer, which is a difficult standard to prove, according to both Nasdaq and the NYSE. An issuer considering this approach should discuss the issuer's circumstances and the proposed transaction and timing with the relevant Exchange. An NYSE-listed issuer should contact the NYSE's Office of the General Counsel or the NYSE's Financial Compliance group. A Nasdaq-listed issuer should contact its Listing Qualifications Analyst or Nasdaq's Corporate Governance Interpretations group and complete a Rule Interpretation Request Form.[19] An NYSE American-listed issuer should contact the NYSE American's Listing Qualifications department.

Obtaining approval from the relevant Exchange generally takes no longer than a week after submitting the application, although it is often possible to obtain approval within a matter of days. Needless to say, some cases are clearer than others.

17 *See* Nasdaq FAQs, Shareholder Approval—Private Placements, available at: https://listingcenter.Nasdaqomx.com/MaterialHome.aspx?mcd=LQ.

18 *See* NYSE Rule 312.05; NYSE American section 710(b)(1); and Nasdaq Rule 5635(f)(1).

19 The Rule Interpretation Request Form and payment instructions are available at: https://listingcenter.Nasdaq.com/ViewPDF.aspx?CGForm.aspx?Preview=CG&Print=N

What actions must an issuer take to avail itself of the financial viability exception?

Under each Exchange's rules, an issuer relying on the financial viability exception must mail a letter to its shareholders ten days in advance of the issuance of the securities. In this letter, the issuer must disclose:

- the terms of the transaction;
- that the issuer is relying on the financial viability exception to the shareholder approval rules; and
- that the audit committee of the issuer or similar disinterested body expressly approved reliance on the exception.

In addition to disclosing the issuer's plan to its shareholders, under Nasdaq Rule 5635(f), an issuer that is granted a financial viability exception is required to make a public announcement by either (a) filing a Current Report on Form 8-K (when required by the SEC rules) or (b) issuing a press release. The press release or Current Report on Form 8-K must be issued or filed promptly, but no later than ten days before the issuance of the securities in reliance on the exception. Under NYSE American section 710(b), issuers must make a public announcement through the news media disclosing the same information as promptly as possible, but no later than ten days before the issuance of the securities. The NYSE American does not require the filing of a Current Report on Form 8-K. Although the NYSE does not specifically require this announcement as part of its financial viability exception, as a practical matter, substantially similar disclosure would be appropriate under most circumstances, due to the materiality of such a situation.

Potential Amendments to the 20% Rule

What amendments to the 20% rule are under consideration?

In November 2015, Nasdaq requested comments on the 20% rule, specifically whether (1) it is too restrictive, (2) the percentage should be higher, (3) there are other shareholder provisions that are sufficient and (4) the insider interest in acquired assets test is still needed. In issuing the request, Nasdaq acknowledged that a variety of factors have changed since the rule was initially enacted. *See* https://goo.gl/H01nmR)

In June 2017, after reviewing the comments received, Nasdaq solicited comments on proposed amendments that would:

- change the definition of market value for purposes of the shareholder approval rules from the closing bid price to a five-day trailing average of the closing price; and
- eliminate the requirement for an issuer to obtain shareholder approval for issuances of common stock at a price less than book value.[20]

As part of these changes, Nasdaq also would require that an issuance of 20% or more of the issuer's outstanding securities be approved by the issuer's independent directors where shareholder approval is not required. The comment period expired on July 31, 2017.

20 *See* Solicitation of Comments by the Nasdaq Listing and Hearing Review Council About the Definition of Market Value for Purposes of Shareholder Approval Rules (June 14, 2017) available at: https://listingcenter.Nasdaq.com/assets/Shareholder%20Approval%20Comment%20Solicitation%20June%2014%202017.pdf.