Securities Law Issues in Volatile Markets

Public Company Advisory Practice (PCAP)

Sean M. Donahue
Jeffrey A. Letalien
Eduardo Aleman
John O. Newell

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Topics Covered

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Introduction

- Capital markets are facing increased volatility in the second half of 2022 resulting in liquidity and capital resource constraints.
- As the market volatility continues in the face of uncertainty connected with rising inflation, the war in Ukraine, shifts in U.S. monetary policy – including increased interest rates, lingering supply chain issues and prolonged emergence from the Covid-19 pandemic – many public companies are increasingly seeking alternative sources of capital.
- There are a variety of issues that arise under the federal securities laws arising from this market volatility.
- Through the first six months of 2022, major stock market indices are down significantly:
  - S&P 500 – (21.08%)
  - DJIA – (15.88%)
  - Russell 3000 – (22.16%)
  - Nasdaq – (29.51%)
  - Nasdaq Biotechnology Index – (20.73%)

Reverse Stock Splits

Reverse Stock Splits – Considerations

When to consider a reverse stock split

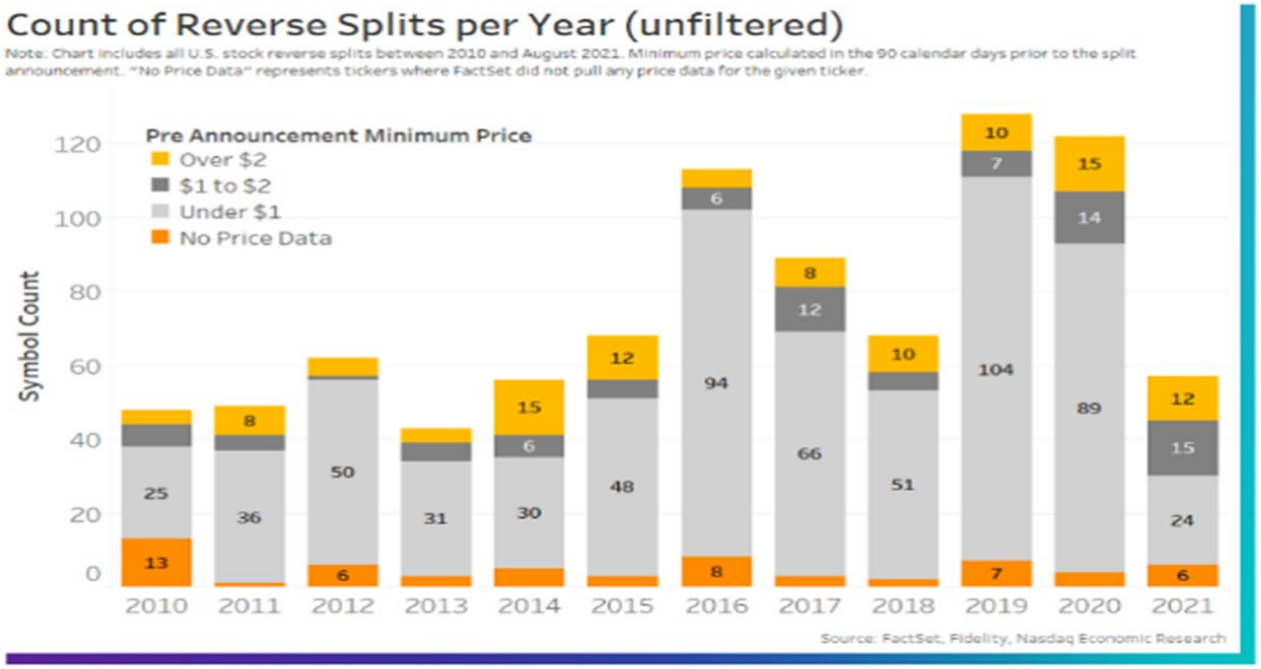
- "Forced"
  - To avoid delisting due to stock price falling below the exchange's minimum price requirement (e.g., Nasdaq rule 5550 minimum bid price $1 per share).
  - Since 2010, over 900 companies have done a reverse split; most have been priced at < $1.
- "Voluntary"
  - To attract investors. Institutional investors and investment funds often have a policy against investing in stock priced below a certain threshold (one study found that 40% of the companies stated expanding and broadening investor base as a reason in their proxy statement).
  - Reduce the number of shareholders in preparation for taking a company private.
  - Reduce the number of small shareholders to reduce servicing costs.

Reverse Stock Splits – Advisability

- Is a reverse stock split advisable?
  - Academic studies show that stock prices tend to drift downward post-split. For example, The Impact of Reverse Splits on Low-Priced Stocks | Nasdaq.
  - Studies indicate that relatively few companies undertake a reverse stock split for voluntary reasons, as compared to in order to meet continued listing requirements.
  - May increase the per share price of a company's stock depending on factors such as the company's fundamentals, and general market conditions, and as a result:
    - appeal to a broader range of investors, including brokerage firms reluctant to recommend lower priced securities to clients, and institutional investors with policies or practices prohibiting them from holding lower-priced stocks in portfolios; and
    - appeal to a broader range of partners and potential new hires, since share price often acts as a barometer of a company's financial standing.

Reverse Stock Splits – Statistics

Chart 2: All (unfiltered) U.S. reverse splits from 2010 to present



Source: Nasdaq, "The Impact of a Reverse Stock Split on Low-Priced Stocks" (October 2021)

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Reverse Stock Splits – Preliminary Considerations

- Do the company's governing documents allow reverse stock splits? Shareholder approval needed, or may board approve without a shareholder vote?
- Determine whether to decrease the number of authorized shares or change par value of the company's stock after the reverse split.
- State law considerations:
  - Amendment to the certificate of incorporation is required to effect a reverse stock split. (e.g., DGCL §242)
  - Shareholder approval of the charter amendment is required, at annual or special meeting of shareholders, or by obtaining shareholder written consent in lieu of meeting. (e.g., DGCL 228, 242)
  - How does state law address fractional shares that may result from the reverse stock split. (e.g., DGCL 155 – company may issue fractional shares or make other arrangements such as paying cash)

Reverse Stock Splits - Preliminary considerations

- Check governing documents for supermajority vote requirement.
- Determine whether consent required from shareholders of certain class of securities, contract counterparties, option holders, etc.
- Early in the process consider, in consultation with transfer agent, mechanics of the split, how to address fractional shares post-split (e.g., issue to the shareholder, cash out, or aggregate and sell to a group of shareholders).
- Obtain a new CUSIP number and notify DTC.

Reverse Stock Splits – SEC Reporting

- Preliminary proxy statement on Schedule 14A when soliciting shareholder vote to approve the amendment to the Certificate of Incorporation to effect a reverse stock split, or Schedule 14C information statement if action taken by written consent of shareholders in lieu of meeting.
  - **Note that charter amendment for reverse stock split is typically a "routine" matter under NYSE Rule 452 for which brokers have discretionary authority to vote.**
- Form 8-K filing required at various stages of the reverse stock split:
  - Amendment to charter documents. (Item 5.03)
  - Post-meeting, to disclose certain information about the meeting and vote results. (Item 5.07)
  - Voluntary filing of Form 8-K for information company determines would be important to shareholders (e.g., when the board determines the ratio for the split). (Item 7.01, or Item 8.01 if incorporated into registration statements)
  - Notice of delisting or failure to satisfy a continued listing requirement. (Item 3.01)

Reverse Stock Splits – SEC Reporting

- Notice of the record date for the reverse stock split required no later than 10 days prior to the record date under Exchange Act Rule 10b-17; can be satisfied by compliance with the exchange's notice provisions
- A company not listed on a national securities exchange must provide notice to FINRA.
- If reverse stock split results in the company going private, file Schedule 13E-3

Reverse Stock Splits

Exchange requirements

- NYSE and Nasdaq rules impose affirmative duty to publicly disclose anything reasonably expected to affect the value of the company's securities. See NYSE Section 202.05; Nasdaq Rule 5250(b)(1).
- Disclosure by press release, or any Regulation FD compliant method.
- Nasdaq Company Event Notification form 15 days prior to the effective date of the split, and notice to Nasdaq MarketWatch at least ten minutes prior to the public release.
- Nasdaq requires a press release by 1:00 p.m. ET the day before post-split trading is to commence, and best practice is to include the new CUSIP number in this release

Impact of reverse stock splits

- Increased number of institutional investors over two years post-split, tends to be at companies whose pre-reverse split stock price was below $5 and the post-split target price is $5.
- Studies indicate that reverse stock splits generally are associated with negative returns.

Reverse Stock Splits – Other Considerations

Proxy voting advisors

- **ISS** – Generally recommends voting for management proposals to implement a reverse stock split if the number of authorized shares will be proportionately reduced, or the effective increase in authorized shares is equal to or less than the allowable increase calculated in accordance with ISS's Common Stock Authorization policy.
- **Glass Lewis** – Policy states that it may recommend voting against a reverse stock split proposal if the board does not state that it will reduce the number of authorized common shares in a ratio proportionate to the split.

Reverse Stock Splits – Other Considerations

- Fractional shares – If the company pays cash for the value of fractional shares, this transaction is exempt from Section 16. See SEC Corp Fin Exchange Act Section 16 and Related Rules and Forms CDI 117.03
- Will impact the company's outstanding options and other forms of equity compensation. For example, under the terms of the company's plans:
  - the number of shares deliverable upon the exercise of options must be adjusted, and
  - appropriate adjustments to the purchase price per share must be made.

Going Dark

(Deregistration and delisting)

Going Dark - Introduction

- During uncertain economic and market conditions, some public companies are forced to assess whether the cost of remaining a public company outweighs the benefits of public company status. These benefits may include access to capital for expansion and repayment of debt, availability of a broad range of incentives for management and employees, and enhanced corporate image.
- Going dark refers to voluntarily delisting a public company's shares from an exchange, and subsequently deregistering the shares under the Exchange Act and terminating the company's public reporting obligations under the Exchange Act.
- Delisting alone does not eliminate public reporting requirements. The company also must deregister its securities under the Exchange Act with the SEC, although reporting obligations may continue in some cases (for example, if the company had a registration statement declared effective during the same fiscal year as when the company attempts to suspend its reporting obligation).
- Deregistration/delisting can typically be accomplished without a shareholder vote.
- Voluntary deregistration and delisting can in some cases be a cost-efficient alternative to a "going private" transaction, which is more complex, lengthy, and expensive.

Going Dark – Deregistration

Eligibility to terminate the registration of a class of securities under the Exchange Act

- A company with a class of securities registered under the Exchange Act that has:
  - Less than 300 record holders, or
  - Less than 500 record holders if the company's total assets have not exceeded $10 million as of the end of the company's three most recent fiscal years.
- Many small cap companies often will fit in one of these two categories regardless of number of beneficial owners, because most beneficial owners hold their stock in street name rather than "of record."

Going Dark – Deregistration

- Eligibility to terminate the registration of a class of securities under the Exchange Act
  - Determine the number of holders of record of the class of securities to be deregistered.
  - Is the company registered under Exchange Act Section 12(b), 12(g), or 15(d)?
  - When a company deregisters its securities in accordance with one of these three sections, the next analysis is whether it is then registered, by default, under another section, and if it is, then it must deregister from that section too.
    - “Ladder” analysis, move down each rung – When deregistered under 12(b), consider whether that class of securities is registered or deemed registered under 12(g), and if 12(g) does not apply then consider whether 15(d) imposes a reporting requirement.

Going Dark – Deregistration for Foreign Private Issuers (FPI)

- FPIs may have an easier path to deregistration under Rule 12h-6.
- FPIs may deregister a class of equity securities under section 12(g) and terminate reporting obligations by meeting certain conditions, including a quantitative benchmark designed to measure U.S. interest in its equity securities that does not depend on a numerical count of U.S. stockholders of record.
- Form 15F immediately suspends the FPI's reporting obligations under the Exchange Act. If the SEC has not objected 90 days after filing the Form 15F, the suspension will automatically become a termination. Form 15F takes effect 90 days from filing, and terminates the FPI's 12(g) registration and reporting obligations under section 13(a) and section 15(d).

Going Dark – Deregistration for Foreign Private Issuers (FPI)

- Conditions for deregistration on Form 15F:
  - must have had reporting obligations under section 13(a) or 15(d) for at least the 12 months preceding the filing of Form 15F;
  - must have filed at least one annual report while it was registered;
  - must not have effected a registered offering in the United States for the 12 months preceding the filing of the Form 15F;
  - must have filed or furnished all reports required for the 12-month period preceding the filing of Form 15F;
  - must have maintained a listing of the class of securities for at least the 12-month period preceding the filing of the Form 15F; **and** satisfy either:
  - the Average Daily Trading Volume test (U.S. ADTV has been no greater than 5 percent of its worldwide trading volume during a 12-month period), ***OR***
  - the record holder benchmark test (less than 300 persons worldwide, or less than 300 persons resident in the United States).

Going Dark - Deregistration

Exchange Act Section	Deregistration eligibility test	Filings
12(b)	Listed on national securities exchange	- Notification to the exchange no fewer than 10 days before filing Form 25 with SEC, and contemporaneous press release and website posting. Rule 12d2-2 - SEC Form 25 – delisting notification filed by exchange or issuer - Withdrawal of registration takes effect 90 days after filing - Delisting from exchange takes effect 10 days after filing - Reporting obligation under Section 13(a) suspended on delisting date – 10 days after filing, even though deregistration is 80 days later.
12(g)	• number of record holders <300; or • number of record holders <500 and assets have not exceeded $10 million as of end of each of three most recent fiscal years	SEC Form 15 under Rule 12g-4 to deregister • 12(g) termination of reporting obligations • Assuming securities were registered under Section 12(b), Form 15 can be filed on delisting date • 12(g) registration terminated 90 days from filing of Form 15
15(d)	In addition to filing obligations that arise under Section 12, Section 15(d) independently requires a company that has filed a registration statement that has been declared effective under the Securities Act to file periodic reports. Rule 12h-3 – any 15(d) reporting obligations are immediately suspended upon filing of Form 15. ▪ cannot suspend for fiscal year in which a Securities Act registration statement becomes effective or is required to be updated by Securities Act Section 10(a)(3), subject to certain exceptions set forth in SLB 18	SEC Form 15 under Rule 12h-3 •Suspension of §15(d) reporting obligations •Due to the limitation in Rule 12h-3(c), Form 15 would not suspend the company's §15(d) reporting obligation if the company had a registration statement declared effective during the fiscal year. As a result, §15(d) reporting obligations would continue, and the company would be required to file its FY22 Form 10-K, and any intervening reports. •§15(d) reporting obligation would continue until company files FY22 Form 10-K, after which its Exchange Act reporting obligations will be suspended. •Company should file post-effective amendments to terminate offerings on any outstanding registration statements prior to filing FY22 Form 10-K. •Company should file Form 15 on Jan. 2, 2023.

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Involuntary Delisting – Nasdaq

- A company may be involuntarily delisted by an exchange if it does not maintain compliance with the exchange's continued listing requirements.
- Under Nasdaq Rule 5810, deficiencies may result in:
  - Immediate delisting (e.g., failure to timely solicit proxies),
  - Opportunity to submit a plan of compliance (e.g., failure to provide Rule 5606 Board Diversity Disclosure), or
  - Automatic 180 calendar-day compliance period for failure to meet minimum bid price continued listing requirement (company may be eligible for an additional 180-day compliance period depending on whether its shares are listed on the Nasdaq Global Select Market, Global Market, or Capital Market).

Minimum bid price continued listing requirement (Nasdaq)

- If a stock's minimum bid price remains below $1 per share for 30 consecutive trading days, Nasdaq will promptly send a deficiency notification.
- Receipt of a deficiency notification triggers disclosure obligations:
  - Nasdaq Rule 5810(b) requires public announcement of a deficiency notification.
  - Item 3.01 of Form 8-K (Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard). A Form 8-K filing can satisfy the Nasdaq disclosure requirement under 5810(b).
- To regain compliance, minimum bid price must be $1 or more for ten consecutive business days to avoid delisting.
- Nasdaq Rule 5810(c)(3) provides a 180-calendar day cure period from the date of deficiency notification to regain compliance.

Minimum bid price continued listing requirement (Nasdaq)

- If company is listed on Nasdaq Global Select Market or Global Market, the company may be eligible for a second 180-calendar day cure period if it transfers to the Nasdaq Capital Market and meets certain requirements. See Nasdaq Rule 5810(c)(3)(A)(i). The company may transfer to the Capital Market prior to the expiration of the initial 180-day compliance period so long as the company:
  - Meets the market value of publicly held shares continued listing requirement,
  - Meets other applicable initial listing requirements, *except for* the minimum bid price requirement, and
  - Notifies Nasdaq of its intent to cure the deficiency.
- If company is listed on Nasdaq Capital Market, the company may be eligible for a second 180-calendar day cure period if by the expiration of the first 180-day compliance period it meets the same requirements listed above. See Nasdaq Rule 5810(c)(3)(A)(ii).

Minimum bid price continued listing requirement (Nasdaq)

- Nasdaq has the discretion to require a company to satisfy the minimum bid price requirement for longer than ten consecutive business days, but generally not more than 20 consecutive business days.
- If it does not appear to Nasdaq that it is possible for the company to cure the deficiency, the company may not be afforded the additional 180-day compliance period.
- A company will often need to conduct a reverse stock split to regain compliance with the Nasdaq minimum bid price requirement. Most companies, however, wait to do this until it is necessary to do so given that historical market reactions to reverse stock splits indicate that stock prices drop back close to the pre-split price in a fairly short period of time.

Other Consequences of Delisting

- SEC reporting
  - Requirements continue unless and until company also de-registers under the Exchange Act and terminates its reporting obligations thereunder.
- Form S-3
  - May not use resale Form S-3 if not listed on national securities exchange.
  - May not be able to comply with registration rights agreements that require company to register privately-placed securities.
- Impact on private resales: loss of Blue Sky pre-emption for private sales
  - Exemption from state “Blue Sky” regulations under Section 18(b)(4)(D) of the Securities Act requires that securities be listed on a national securities exchange.
  - Once shares are delisted, may have to find Blue Sky exemptions for every state in which sales or resales occur.

Loss of WKSI status

Loss of WKSI status

- A recent decline in stock prices of many companies' common stock has resulted in reduced market capitalization and public float.
- One impact of a reduced public float could be the loss of status as a well-known seasoned issuer ("WKSI"). A company that qualified as a WKSI at the time it filed its automatic shelf registration statement may lose that status when it files its annual report or new registration statements.
- The test for WKSI status requires, among other things, that the issuer have a worldwide market value of its outstanding voting and non-voting common equity held by non-affiliates (public float) of $700 million or more, as of a date within 60 days of the determination date.

Loss of WKSI status (cont.)

- Determination date is latest of:
  - Time of filing of the most recent shelf registration statement, or
  - Time of the most recent amendment to a shelf registration statement for purposes of complying with Securities Act Section 10(a)(3), which is the date of the filing of an annual report on Form 10-K or 20-F.
- A company may continue to use its previously filed WKSI shelf registration statement even if its market cap drops below $700 million as form eligibility is only retested at the time of the Section 10(a)(3) update

Loss of WKSI Status – Maintaining a Shelf Registration Statement

- SEC Securities Act Rules CDI 198.06 addresses the procedure to follow to permit uninterrupted access to the use of Form S-3 after loss of WKSI status.
- The company must take some of these steps before filing its Form 10-K annual report, so it is essential that a company that has filed a Form S-3 automatic shelf registration statement (ASR) that has an upcoming Form 10-K filing to determine as soon as possible if it is at risk of losing WKSI status.
- A company that loses WKSI status at the time of filing its Form 10-K may continue to offer and sell securities from its ASR pending the effectiveness of the post-effective amendment that it would need to file in order to convert the ASR to a non-automatic shelf registration statement on Form S-3.

Loss of WKSI Status – Maintaining a Shelf Registration Statement

- The company must meet the following conditions to continue using a Form S-3 registration statement:
  - Prior to filing the Form 10-K, the company must amend the ASR so that it conforms to the requirements that apply to a Form S-3 filed in reliance on General Instruction I.B.1 or I.B.2.
  - The company must file a post-effective amendment to the ASR (POSASR on EDGAR) to register a specific amount of securities and pay the associated filing fee at the time of filing.
  - The company must file a prospectus in the post-effective amendment to the ASR must contain all information required to be included in a Form S-3 filing in reliance on General Instruction I.B.1 or I.B.2. The prospectus may not omit information in reliance on Rule 430B provisions available only for an ASR.
  - The company must remain eligible to use Form S-3 in reliance on the General Instructions above at the time of the 10-K filing.
  - Promptly after the Form 10-K filing, the company must file either a post-effective amendment using EDGAR submission type POS AM or a new Form S-3 registration statement to convert the ASR to the proper EDGAR type for non-automatic shelf registration statements.
  - Pending the effectiveness of the filing, the company may continue to offer and sell securities using the amended ASR.

Exchange Act Filing Status

Filer Status Overview

- **Accelerated Filer** – company with a public float as of the last business day of the company's second fiscal quarter between $75 million and $700 million that has been public for at least a year.
  - *Key impact*: – earlier 10-Q and 10-K filing deadlines; obligation to file an auditor's attestation of management's assessment of internal control over financial reporting (an Auditor Attestation).
  - *Note*: An EGC or an SRC can be an accelerated filer; an SRC that is an accelerated filer must file an Auditor Attestation.
- **Large Accelerated Filer** – company with a public float of >$700 million that has been public for at least a year.
  - *Key impact*: – earliest 10-Q and 10-K filing deadlines; Auditor Attestation obligation
- **Non-Accelerated Filer** – company that doesn't meet the prior two tests.
  - *Key impact*: Later filing deadlines; no Auditor Attestation obligation.

Issuer Category Overview

- Emerging Growth Company (EGC) – company with revenue of less than $1.07 billion that has issued less than $1 billion in non-convertible debt.
  - A company generally qualifies as an EGC until the earlier of (1) the date that it becomes a large accelerated filer, (2) the last day of the fiscal year in which total gross revenues are $1.07* billion or more, or (3) the last day of the fiscal year ending after the fifth anniversary of its IPO.
    * The SEC is expected to adjust this amount for inflation during 2022.
  - EGC status terminates immediately upon issuance of more than $1 billion of non-convertible debt by the company during a rolling three-year period. This test is based on the amount issued by the company and its subsidiaries (including refinanced debt), not the amount outstanding.
  - Key impacts: Reduced reporting obligations in terms of financials, executive compensation and other proxy sections; no Auditor Attestation required.
- Smaller Reporting Company (SRC) – company with revenue of less than $100 million and a public float of less than $700 million or a public float of less than $250 million (no matter the revenue level).
  - SRC status is re-evaluated annually.
  - Note: An EGC may also be an SRC.
  - Key impacts: Reduced disclosure and other obligations; no Auditor Attestation required unless the SRC is an accelerated filer.

Change of filer status based on public float

Initial Filer Status	Subsequent Public Float	Resulting Filer Status
Large Accelerated Filer	$560M or more	Large Accelerated Filer
	Less than $560M, but $60M or more	Accelerated Filer
	Less than $60M	Non-Accelerated Filer
Accelerated Filer	$700M or more	Large Accelerated Filer
	Less than $700M, but $60M or more	Accelerated Filer
	Less than $60M	Non-Accelerated Filer
Non-Accelerated Filer	$700M or more	Large Accelerated Filer
	Less than $700M, but $75M or more	Accelerated Filer
	Less than $75M	Non-Accelerated Filer

Smaller Reporting Companies, Non-Accelerated, Accelerated, and Large Accelerated Filers

Relationships between Smaller Reporting Companies and Non-Accelerated, Accelerated, and Large Accelerated Filers under the Amendments		
Status	**Public Float**	**Annual Revenues**
Smaller Reporting Company and Non-Accelerated Filer	Less than $75 million	N/A
	$75 million to less than $700 million	Less than $100 million
Smaller Reporting Company and Accelerated Filer	$75 million to less than $250 million	$100 million or more
Accelerated Filer (not a Smaller Reporting Company)	$250 million to less than $700 million	$100 million or more
Large Accelerated Filer (not a Smaller Reporting Company)	$700 million or more	N/A

Decrease in Public Float or Revenue

- SRC revenue tests apply. Large Accelerated Filer or Accelerated Filer can transition to non-accelerated filer status if the company qualifies as an SRC under SRC revenue test.
- SRC revenue test:
  - Once a company does not qualify as an SRC, it remains unqualified until:
    - It determines under the public float test that it has a public float of less than $200 million (regardless of revenue); or
    - It determines that its public float and its annual revenues meet the requirements for subsequent qualification included in the following chart

Decrease in Public Float or Revenue

Prior Annual Revenues (for the fiscal year before the most recently completed fiscal year)[3]	Prior Public Float (as of the second quarter of the fiscal year before the most recently completed second fiscal quarter)[4]			
	None or less than $700 million		$700 million or more	
Less than $100 million	Neither threshold exceeded; company remains an SRC.		**Public float required:** (as of the most recent second fiscal quarter)[5]	Less than $560 million; and
			Revenues required: (for the most recently completed fiscal year)[6]	Less than $100 million.
$100 million or more	**Public float required:** (as of the most recent second fiscal quarter)	None or less than $700 million; and	**Public float required:** (as of the most recent second fiscal quarter)	Less than $560 million; and
	Revenues required: (for the most recently completed fiscal year)	Less than $80 million.	**Revenues required:** (for the most recently completed fiscal year)	Less than $80 million.

[3] For example, for a company with a December 31 fiscal year making a determination on June 30, 2020, “prior annual revenues” would be its annual revenues for the fiscal year ended December 31, 2018.

[4] For example, for a company with a December 31 fiscal year making a determination on June 30, 2020, “prior public float” would be its public float as of June 28, 2019.

[5] For example, for a company with a December 31 fiscal year making a determination on June 30, 2020, “public float required” would be as of June 30, 2020.

[6] For example, for a company with a December 31 fiscal year making a determination on June 30, 2020, “revenues required” would be for the fiscal year ended December 31, 2019.

Decrease in Public Float or Revenue

- A company should determine on an annual basis if it satisfies the conditions to qualify as an SRC.
- Public float determination is made as of the last business day of the company's second fiscal quarter.
- A company that satisfies the conditions of the SRC definition in Rule 12b-2 based on (i) public float, or (ii) public float and revenues as of the last business day of its second fiscal quarter will typically be a non-accelerated filer subject to the exception described below.
- As a result, the non-accelerated filer deadlines will apply, and the company would no longer be required to obtain an attestation report from its independent auditor on the effectiveness of the company's ICFR.
  - Note: A non-accelerated filer will remain obligated, among other things, to establish and maintain ICFR and, as required by SOX Section 404(a), and have management assess the effectiveness of ICFR.
- Although most companies that qualify as an SRC will be non-accelerated filers, those that have a public float of $75 million or more to less than $250 million as of June 30, 2022 and had annual revenues of $100 million or more for the fiscal year ended December 31, 2021 will be accelerated filers even though they are SRCs. Among other consequences, the company will be required to file an Auditor Attestation.

Baby Shelf Rule

Baby Shelf Rule

- Baby shelf rule: SEC rules provide relief for small cap companies that do not meet the $75 million public float requirement to use Instruction I.B.6 of Form S-3.
  - The company can sell up to 1/3 of its public float during a 12-month period.
- A company may not evade the offering size limitations of this Form S-3 instruction by selling securities to the same primary offering investor(s), with a portion coming from a takedown from its shelf registration statement for which it is relying on Instruction I.B.6 and a portion coming from a separate private placement that it concurrently registers for resale on a separate Form S-3 in reliance on Instruction I.B.3, if the aggregate number of shares sold exceeds the I.B.6 limitation. See SEC staff guidance in Form S-3 CDI 116.25.

Baby Shelf Rule

- **Baby shelf eligibility**: Issuers with less than $75 million non-affiliate public float may file and use a Form S-3 provided they (i) meet the eligibility requirements of Form S-3, (ii) have a class of common equity securities that is listed and registered on a national exchange and (iii) they do not sell more than the equivalent of one-third (1/3) of their public float in primary offerings on Form S-3 during the preceding 12 calendar months.
- **When eligibility is assessed**:
  - Whether a company is subject to the baby shelf rule limitations is initially determined at the time the Form S-3 is filed. If the public float was at least $75 million within 60 days prior to filing the Form S-3, there is no 1/3 public float limitation initially.
  - The standard is reassessed every time a company files a Form 10-K. As a result, even if the Form S-3 is filed when a company has a public float greater than or equal to $75 million, if the company's public float was not at least $75 million within 60 days prior to the filing of a subsequent Form 10-K, the company will be subject to the Baby Shelf Rule limitation going forward until the requisite float is regained.
  - If the public float subsequently meets or exceeds $75 million after the Form 10-K is filed on any one day, a company is no longer subject to the 1/3 public float limitation until the next re-evaluation date (i.e., the next Form 10-K).

Baby Shelf Rule

- **Calculation of amount of securities under the baby shelf rule**:
  - Public float must be determined immediately prior to any sale.
  - However, issuers can calculate public float as of a day within sixty days of the date of the sale.
  - Can pick highest stock price during any sixty-day period and largest public float during any sixty-day period; in other words can mix and match days.
  - Consider need for Rule 424 “stickers” prior to a sale when subject to baby shelf rule.
  - If the company enters into an equity line financing (i.e., a committed equity financing) the entire amount counts against baby shelf limit at time of execution of equity line agreement; cuts in favor of doing equity line as resale offering on Form S-1 to not reduce baby shelf limit.
  - All sales pursuant to primary offerings in the previous 12-month period (including the intended sale) must be aggregated to determine whether the one-third public float limitation would be exceeded.

Stock Repurchases

Stock Repurchases

- Advantages/benefits of stock repurchases:
  - Signal to the market that its shares are undervalued and, therefore, a good investment, particularly in a volatile market;
  - Lack of profitable investment opportunities for excess cash;
  - Distribute capital to shareholders in a more tax-efficient manner (for shareholders) than declaring dividends;
  - Acquire shares for employee equity compensation plans;
  - Offset the dilutive impact of M&A activity and employee stock option exercises;
  - Reduce outstanding share count, increase EPS or other metrics based on the number of outstanding shares; and
    - Studies show share price typically increases 1-3% after repurchase announcement, and announcement effect does not dissipate over time, which suggests that repurchases are rarely intended to increase EPS (see SEC 2020 Study).
  - More concentrated ownership.

Stock Repurchases

- Disadvantages
  - Perception that repurchases enrich company executives who control the timing of share repurchases.
  - Perception that the company could use the excess cash for other investment purposes (e.g., increase wages, R&D, invest in new equipment and innovation, M&A).

Stock Repurchases

- How a company may conduct repurchases:
  - Open market purchases (represents 91% of repurchases, based on SEC 2016-2019 data);
  - Privately negotiated repurchases (5%);
  - Issuer tender offers (1%) – allows repurchase of a large number of shares at once without being subject to Rule 10b-18 volume limitations; and
  - Structured programs, including accelerated share repurchase programs.

Stock Repurchases

- Open market repurchase
  - Publicly disclose share repurchase program through Form 10-Q or 10-K, a press release or a Form 8-K. Stock exchanges consider this to be material information that would reasonably be expected to affect the value of its securities.
  - Announcement may be made well in advance of actual commencement of purchases and prior to development of concrete plans as to timing and manner of purchases, but the company should have a good faith expectation as of the time of announcement that it will make repurchases under the program in the future. Only minimal information such as the overall share or dollar size of the program must be disclosed at the time of announcement.
  - Company may not initiate a share repurchase, or establish a plan under Rule 10b5-1 to do so in the future, when in possession of MNPI.
  - More detailed quarterly disclosure required in the company's Form 10-K and Form 10-Q reports.

Stock Repurchases

- Mechanics
  - Board approval – Board must approve repurchase program, including the maximum number of shares, or maximum dollar amount of shares to be repurchased, and intended method of repurchase. State corporate law may require additional board action.
  - Public announcement (as described above).
  - Execute according to Rule 10b-18 buyback safe harbor.
  - MNPI restrictions (Rule 10b-5) – Safe harbor does not apply if buybacks made while in possession of MNPI.
  - SEC disclosure following repurchases in 10-Q and 10-K.

Stock Repurchases

- Managing Material Non-Public Information (MNPI)
  - Purchases may be initiated by management (pursuant to delegated authority from the board) on a daily basis during trading windows, as long as the company and the officer making the decision do not have MNPI
  - Alternatively, the company can enter into a 10b5-1 repurchase plan with a broker during an open trading window (assuming lack of MNPI at the time of execution) and enable a broker to make purchases during blackout periods on “autopilot” pursuant to a predetermined formula.
  - Rule 10b-18 safe harbor limits repurchases to one broker on any single day.
  - Important to only use one broker if using a 10b5-1 plan because of inability to prevent purchases by multiple brokers on the same day.

Stock Repurchases

- Item 703 of Regulation S-K currently requires the following disclosure:
  - Disclosure of purchases of securities by the issuer and affiliated purchasers for each month included in the period covered by the report (fourth quarter for Form 10-K reports); Item 15(e) of Form 20-F requires similar disclosure by foreign private issuers.
  - Applies to all issuer repurchases, whether open market or private transaction, including purchases that do not satisfy Rule 10b-18 safe harbor conditions.
  - Tabular disclosure of (i) total number of shares purchased; (ii) average price paid per share; (iii) total number of shares purchased as part of publicly announced repurchase plan; (iv) maximum number of shares (or approximate dollar value) of shares that may yet be purchased under the plan.
  - Footnote disclosure of date plan announced, dollar amount approved, expiration date of plan, each plan or program that has expired during the period covered by the table, and each plan or program the company has decided to terminate prior to expiration.

Stock Repurchases

- Rule 10b-18 safe harbor
  - Exchange Act Sections 9(a)(2) and 10(b), Rule 10b-5 anti-manipulation provisions apply.
  - MNPI – If company in possession of MNPI, company must either disclose the information (and give the market sufficient time to absorb the information, typically one full trading day), or refrain from trading.
  - Illegal to conduct a series of transactions creating actual or apparent active trading in a security to induce others to buy or sell the security.
  - Purchases of a firm's own shares could be considered manipulative if the intent of the repurchase is to drive up the stock price by creating the appearance of heavy demand.
  - SEC enforcement case Andeavor (2020) – SEC charged that the company failed to maintain internal accounting controls that provided reasonable assurance that the company's stock repurchase complied with the company's policy prohibiting repurchases while in possession of MNPI.

Stock Repurchases

- Rule 10b-18
  - Rule 10b-18 is a voluntary, nonexclusive safe harbor from anti-manipulation liability when shares are purchased by the issuer according to the rule's conditions on manner, timing, price and volume.
    - *Manner* – Repurchases conducted through only one broker or dealer each day
    - *Timing* – Company generally may not make the opening reported purchase. Additional conditions apply to bids for or purchases during the last 10 or 30 minutes (depending on average daily trading volume (ADTV) of the company's securities) before the scheduled close of the primary trading session
    - *Price* – Company may not purchase its common stock at a price that exceeds the highest independent bid or the last independent transaction price (whichever is higher)
    - *Volume* – Up to 25% of the ADTV of company's common stock, including block purchases made by or on behalf of the company for that day.

Stock Repurchases

Rule 10b-18

- Rule 10b-18 applies on a daily basis. To come within the safe harbor, repurchases must satisfy each of the conditions on a daily basis. Failure to meet any of the four conditions will remove all of the repurchases from the safe harbor for the day.
- No presumption that an issuer or affiliated purchaser has violated the anti-manipulation provisions if Rule 10b-18 conditions are not satisfied.
- Rule does not apply to tender offers.
- Rule 10b-18 does not provide any protection against violation of any other anti-fraud or anti-manipulation prohibitions under Exchange Act Sections 9(a)(2) and 10(b), and Rule 10b-5.
- MNPI – If company in possession of MNPI, company must either disclose the information (and give the market sufficient time to absorb the information, typically one full trading day), or refrain from trading.
- Illegal to conduct a series of transactions creating actual or apparent active trading in a security to induce others to buy or sell the security.
- Purchases of a company's own shares could be considered manipulative if the intent of the repurchase is to drive up the stock price by creating the appearance of inflated demand.

Stock Repurchases

- Recent developments to consider
  - SEC proposed new disclosure requirements relating to repurchases, Share Repurchase Disclosure Modernization (December 15, 2021).
  - New Form SR would require daily purchase disclosure, one business day after execution of an issuer's share repurchase order. New disclosures would include:
    - Total number of shares (or units) purchased in reliance on the Rule 10b-18 safe harbor, and
    - Total aggregate number of shares (or units) purchased pursuant to a plan that is intended to satisfy the affirmative defense conditions of Rule 10b5-1(c).

Stock repurchases (Cont.)

- Item 703 of Regulation S-K proposed additional disclosures would include, among others:
  - the objective or rationale for the share repurchase and process or criteria used to determine the amount of repurchases;
  - policies and procedures relating to officer and director repurchases;
  - disclosures highlighted above in Form SR; and
  - mandated disclosure in Form 10-K whether or not issuer has adopted insider trading policies/procedures that govern the purchase, sale or other disposition of the company's securities by directors, officers and employees reasonably designed to promote compliance with insider trading laws; and these policies would be subject to SOX 302 certifications.

Stock Repurchases - Other Considerations

- In January 2021, the SEC proposed amendments to Rule 10b5-1 that would, among other things:
  - add new conditions to the availability of the affirmative defense in Rule 10b5-1(c)(1); and
  - create new disclosure requirements.
- The proposed amendments would add new conditions to the availability of the Rule 10b5- 1(c)(1) affirmative defense to insider trading liability, including:
  - 10b5-1 trading arrangements entered into by corporate officers or directors must include a 120-day cooling-off period before any trading can commence under the trading arrangement after its adoption, including adoption of a modified trading arrangement;
  - 10b5-1 trading arrangements entered into by issuers would be required to include a 30-day cooling-off period before any trading can commence under the trading arrangement after its adoption, including adoption of a modified trading arrangement;
  - Officers and directors would be required to certify that they are not aware of material nonpublic information about the issuer or the security when adopting a new or modified trading arrangement;

Stock Repurchases - Other Considerations

- The affirmative defense under Rule 10b5-1(c)(1) would not apply to multiple overlapping Rule 10b5-1 trading arrangements for open market trades in the same class of securities;
- 10b5-1 trading arrangements to execute a single trade would be limited to one plan per 12 month period; and
- 10b5-1 trading arrangements would be required to be entered into and operated in good faith.

Stock Repurchases - Other Considerations

- State corporate law. For example, Del. Gen. Corp. Law Section 160 prohibits a corporation from purchasing its shares if it would cause “any impairment of the capital of the corporation.”
- Existing agreements may prohibit or limit company’s ability to repurchase its securities (e.g., credit agreements, public debt indentures and other debt arrangement).
- Stock exchange rules regarding advance notice of material corporate developments.
- Internal controls. 2020 SEC Enforcement action against Andeavor LLC for failure to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that stock buyback transactions were executed in accordance with management’s authorization.
- Regulation M. A company will generally need to suspend a repurchase program if it intends to undertake a distribution of the securities that are the subject of the repurchase plan.

Alternative Financings

Alternative Financings Overview

- In volatile markets, companies seeking to raise capital are increasingly considering alternative financing transactions.
- A traditional follow-on underwritten registered offering may not be feasible for all companies.
- This presentation highlights a number of these alternatives.
- For a more detailed discussion of each of these alternatives, see *Financing Alternatives for Public Companies* (April 2022) Capital Markets and PCAP training. http://inet.goodwinprocter.com/worksite/scripts/GetDoc.aspx?latest=0&nrtid=!nrtdms:0:!session:goodwindms:!database:ACTIVE:!document:116440005,1:&

GOODWIN

Alternative Financings Overview

- **CMPO (Confidentially Marketed Public Offering)**
  - Registered public offering pursuant to an effective shelf registration statement; commences with Reg FD-compliant wall-crossed marketing by underwriters.
- **PIPE (Private Investment in Public Equity)**
  - Private placement by a public company; exempt from registration. No need to have an effective shelf registration statement or to qualify for short form registration statement on S-3 or F-3. There will, however, typically be a registration rights agreement requiring filing a subsequent resale shelf registration statement.
- **ATM (At the Market Offering)**
  - With an effective registration statement and a prospectus supplement describing the ATM, issuer relies on a placement agent to offer securities for sale over time in an existing trading market at publicly-available bid price – often anonymously through electronic exchanges.

Alternative Financings Overview

- **Registered Direct Offering (RD)**
  - Registered offering pursuant to an effective shelf registration statement. Can be done with or without a placement agent. Can be marketed confidentially.
- **Equity Line Financing**
  - Issuer and capital provider agree to an arrangement where provider agrees to purchase a maximum dollar amount of shares from issuer; issuer has right to “put” its shares from time to time (number of shares purchased determined by a market-price formula).
- **Convertible Notes Offering**
  - Registered or privately placed debt convertible into equity at a conversion price.
- **Rights Offering**
  - Offering to existing equity holders of a company to participate in a financing round on pro rata basis, mitigating dilution to existing shareholders versus offering to new investors. Newly-issued securities underlying rights may include common or preferred stock, warrants, debt or a combination. Usually includes standby arrangements that provide for a registered underwritten offering of the securities underlying the rights that existing equity holders do not exercise.

Option Repricing

Stock Option Repricing

- Introduction
- Key Considerations
  - Stockholder approval
  - Tender offer rules
  - Accounting and Stock Impact
- Different Approaches to Repricing
  - One-for-One Exchange
  - Option-for-Option Exchange
  - Option-for-Stock Exchange
  - Option-for-Cash Exchange
- Process Notes

Introduction to Stock Option Repricing

- Through the first six months of 2022, major stock market indices are down significantly:
  - S&P 500 – (21.08 %)
  - DJIA – (15.88 %)
  - Russell 3000 – (22.16 %)
  - Nasdaq – (29.51 %)
  - Nasdaq Biotechnology Index – (20.73 %)
- For many employees, stock options they are holding may be under water and have no value.
- That represents a retention and motivation issue for employers in what remains a highly competitive market for talent in many areas of the U.S. To address that, many companies will consider a stock option repricing program.

Introduction to Stock Option Repricing

- A stock option repricing typically refers to (i) an exchange of existing stock options for new stock options with lower exercise prices (at or above the current fair market value of the company's stock) or the amendment of the existing stock options to lower the exercise prices or (ii) a value-for-value exchange of existing stock options for (a) new stock options to purchase fewer shares with exercise prices at or above the current fair market value of the company's stock, (b) other forms of equity awards (such as restricted stock or restricted stock units (RSUs)) or (c) cash.
- The following discussion is focused on the issues facing exchange-listed U.S. public companies contemplating a stock option repricing program.

Stock Option Repricing – Key Considerations

- Will stockholder approval be required?
- Will tender offer rules apply?
- Who will participate in the repricing program?
  - Do you include senior executive officers and directors? If retention is goal of program, these may be among the most important employees to retain and motivate. However, including them can also significantly raise the cost of the program.
  - If stockholder approval is required, including senior executive officers and directors may make securing stockholder approval more difficult because ISS, Glass Lewis, significant stockholders and others may balk at supporting the program.
- Which stock options will be repriced?
  - All underwater stock options? Only those stock options that are significantly underwater? Only stock options issued prior to a specified date?

Stock Option Repricing – Key Considerations

- Determination of exchange ratio for value-for-value exchanges
- Accounting and tax ramifications
- How to structure the program
- Stockholder approval
  - NYSE and Nasdaq require stockholder approval for any material amendment to an equity compensation program, including any stock option repricing, unless a company's equity compensation plan expressly permits repricing without stockholder approval (which is rare because such a feature is viewed negatively by institutional shareholders and proxy advisory firms).
  - The approval requirement will apply to most of the approaches to repricing discussed below.
  - Stockholders may have little enthusiasm for approving a repricing because they will have suffered from a falling stock price as well without similar recourse available.

Stock Option Repricing – Key Considerations

- Obtaining the support of institutional shareholders and proxy advisors is an important factor in securing shareholder approval for a stock option repricing. Leading proxy advisory firms, such as ISS and Glass Lewis, have published detailed voting guidelines related to repricing's.
- These guidelines severely limit companies' options for structuring an effective repricing program. For example, to obtain the support of proxy advisory firms, companies need to exclude executive officers and directors from participating in the program.
- Companies seeking stockholder approval for a stock option repricing must solicit proxies in accordance with Section 14A of the Exchange Act and the rules thereunder. This will typically include filing a preliminary proxy statement at least 10 days prior to mailing the definitive proxy materials to allow for SEC review.

Stock Option Repricing – Key Considerations

- Tender offer rules
  - U.S. tender offer rules are generally implicated when a securityholder is required to make an investment decision with respect to the purchase, modification or exchange of a security.
  - A one-to-one exchange, where the repricing is effected solely by modifying the exercise price of the underwater stock option (e.g., repricing by amending the exercise price of a stock option or by a cancellation of the underwater stock option in exchange for a newly-priced stock option on a one-to-one basis), will generally not trigger U.S. tender offer rules as there is typically no investment decision required by the holder of such stock options under these circumstances.
  - However, a value-for-value exchange will implicate tender offer rules as it requires optionholders to decide whether or not to accept a stock option to purchase fewer shares or to exchange their existing stock options for other forms of equity awards or cash. Additionally, the SEC considers a repricing of stock options requiring the consent of optionholders to be a self-tender offer by the issuer of the stock options.
  - These tender offer rules require issuers to provide participants with detailed disclosures about the tender offer in the form of an Offer to Exchange document and a Schedule TO filing. The offer must remain open for 20 business days.
  - Complying with tender offer rules can be expensive and time consuming.

Stock Option Repricing – Key Considerations

- Accounting impact
  - Companies will want to determine whether their repricing structure will result in an additional accounting charge. Any such accounting consequences must be stated in the Schedule TO filed with the SEC if the repricing is subject to U.S. tender offer rules.
  - FASB ASC Topic 718 requires that public companies describe the repricing program in the stock plan footnote to their financial statements (including the terms of the program, the number of employees who participated in it and any incremental compensation cost to be recognized).

Stock Option Repricing – Key Considerations

- U.S. tax impact
  - For stock options grandfathered under Section 162(m), repricing of such stock options is a material modification, which will cause the loss of grandfathered status for those stock options such that the $1 million deduction limit may apply.
  - For stock options intended to qualify as “incentive stock options” under Code Section 422 (“ISOs”), a stock option repricing, even if only the exercise prices are amended, is considered the cancellation of existing stock options for the grant of new stock options. Thus, when an ISO is cancelled pursuant to a stock option repricing, any stock option shares scheduled to become issuable in the calendar year of the cancellation would continue to count against the $100,000 limit for that year, even if the cancellation occurs before the stock options’ shares actually become issuable.

Overview of Stock Option Repricing Approaches

There are generally two approaches to a stock option repricing:

- One-for-One Exchange
  - Amending the terms of existing stock options to lower the exercise price to market
  - Cancelling existing stock options and issuing new ones with lower market exercise price
- Value-for-Value Exchange
  - Cancelling existing stock options and issuing new stock options that have an overall value that is equal to or less than the value of the canceled ones
  - Cancelling existing stock options in exchange for shares of restricted stock or RSUs that have the same or lower economic value than the canceled stock options.
  - Repurchasing underwater stock options for cash for an amount based on Black-Scholes or another option pricing methodology. Most public company option plans do not allow for this approach.

Stock Option Repricing – One-for-One Exchange

- Company unilaterally (i) reduces the exercise prices of the relevant underwater stock options to an amount equal to or above the fair market value of the shares on the date of the repricing via an amendment to the relevant stock option agreements or (ii) cancels the underwater stock options and replaces them, on a one-for-one basis, with stock options at the reduced exercise price.

Pros	Cons
• Easily communicated and understood by optionholders (assuming no other changes to the stock option terms) • Allows optionholders to maintain control over the taxable event (i.e., tax at exercise) • Not likely to trigger U.S. tender offer rules or require optionholder consent	• Stockholder approval required • Often considered a “windfall” for optionholders and is likely to face stockholder resistance given that stockholders do not receive the same economic benefits provided to optionholders • Likely to face negative recommendations from proxy advisory firms • Repriced options remain susceptible to going underwater

Stock Option Repricing – Fair Value Option-for-Option Exchange

- An option-for-option exchange is carried out by replacing underwater stock options with new stock options to purchase a lower number of shares that are priced at the current fair market value. This method exchanges underwater stock options for new stock options on a “value-for-value” basis, where the value of the exchanged stock options, based on a commonly accepted valuation method (e.g., Black Scholes or binomial lattice model) is equal to, or less than, the value of the underwater stock options being cancelled, resulting in an exchange ratio of less than one-to-one.

Pros	Cons
• Allows optionholders to maintain control over the taxable event (i.e., tax at exercise) • Viewed more favorably by investors and proxy advisory firms than a one-for-one exchange • Provides a company with an opportunity to reduce issued equity overhang and preserve share reserve under equity compensation plan • Does not result in an accounting charge if the value of the new stock options is equal to or less than the value of the exchanged underwater stock options	• Stockholder approval required • More difficult for optionholders to understand than a one-for-one exchange and may require more employee communication efforts • Requires determination of proper exchange ratio to use • Will likely trigger U.S. tender offer rules • Repriced stock options remain susceptible to going underwater

Stock Option Repricing – Option-for-Stock Exchange

- An option-for-stock exchange is a variation of the option-for-option exchange as described above where, instead of exchanging underwater stock options for new stock options, the underwater stock options are cancelled in exchange for a different form of equity award (e.g., restricted stock or RSUs).

Pros	Cons
• Eliminates the possibility of future underwater stock options • Viewed more favorably by investors and proxy advisory firms than a one-for-one exchange • Significantly eliminates equity overhang and can preserve share reserve under equity compensation plan	• Stockholder approval required • Often difficult and more complicated to explain to employees • Requires determination of proper exchange ratio to use • Will likely trigger U.S. tender offer rules • Company employees do not maintain control of the taxable event (i.e., tax at vesting for restricted stock or at settlement for RSUs) • Stock grants are generally viewed as presenting a lower upside compared to stock options, arguably reducing the incentive feature

Stock Option Repricing – Option-for-Cash Exchange

- An option-for-cash exchange is achieved by cancelling the underwater stock options in exchange for the cash value of those stock options, based on a commonly accepted valuation method (e.g., Black Scholes or binomial lattice model).

Pros	Cons
• Significantly eliminates equity overhang and can preserve share reserve under the equity compensation plan • Easily explained and understood by employees • Eliminates the possibility of future underwater stock options • Provides immediate value to participants • If cash repurchase is permitted by the option plan, stockholder approval not required	• Requires determination of proper exchange ratio to use • Immediately taxable upon payment • Will likely trigger U.S. tender offer rules • Requires a cash outlay, which may not be prudent for a company looking to conserve cash • The incentive and retention features of stock options are lost

Stock Option Repricing – Process Notes

Stock option repricing programs usually include the following, among others:

- Board approval
  - Recommendation that stockholders approve the program
  - Determination of exchange ratio used; may need to retain an independent valuation firm
  - Approval of other terms of the program (e.g., approach used, eligible stock options, new vesting periods, director and officer participation)
- Stockholder approval
  - Potential outreach to institutional investors
  - Review voting policies of ISS, Glass Lewis and significant stockholders

Stock Option Repricing – Process Notes

- Preparation of documents for SEC filings
  - Proxy Statement (preliminary and definitive)
  - Schedule TO for tender offer
  - Post-exchange: Section 16 filings for directors and officers participating; discussion in next year's proxy statement CD&A
- Preparation of communications materials for optionholders to explain the change (include with Schedule TO)
- Coordination with accounting and tax advisors
  - Including assessing accounting treatment, ISO limits and potential 162(m) impact
- Confirmation that company has sufficient shares available for new issuances under charter and option plan for new issuances

Considerations in Granting RSUs

Considerations in Granting RSUs

- Overview
- How many RSUs to grant
- Share counting
- Vesting terms
- Tax withholding

RSU Overview

- A restricted stock unit – an RSU – represents the right to receive shares of company stock, or the equivalent value, in the future when the RSU vests.
  - RSUs typically settle in shares of stock of the issuing company.
  - It is possible, however, for RSUs to settle in cash (based on the value of the company's stock at the time of vesting); this is relatively rare as cash-settled instruments may have unfavorable accounting treatment.
- No shares are issued at the time of grant.
  - The holder does not have voting rights until the RSUs vest and shares are issued.
  - The holder likewise does not have dividend rights.
- There is no exercise price for an RSU; it is, therefore, considered a "full value award."

RSU Overview

- Like stock options, RSUs are governed by a grant agreement and the governing equity incentive plan that set forth the relevant award terms, which for RSUs include vesting terms and schedule, tax-related provisions, what happens upon a change in control, what happens when the holder's relationship with the company ends and other matters.
- Sale deemed to occur at time of grant for Securities Act purposes.
- In a down market, companies may change their equity practices to issue more RSUs.
- RSUs could be issued to replace underwater stock options (as discussed earlier).
- RSUs also could be issued in lieu of new stock options if the stock price is declining and there are questions about the retentive value of options.
- RSUs also generally require the use of fewer shares under an equity incentive plan which may be important if granting significant retention or inducement grants.

Pricing RSUs

- In granting RSUs, companies often make a grant expressed as a fixed dollar amount – for example $200,000.
- A company's compensation committee then determines how many RSUs to issue to reflect that grant value:
  - Most typical is to divide the value by the closing stock price on the grant date. If the closing sale price of a share of the company's stock on the date of grant is $50, the $200,000 grant would result in an award of 4,000 RSUs.
  - As a company's stock price falls or rises, the number of RSUs it grants increases or decreases, respectively.
  - For volatility reasons or to mitigate the impact of a recent stock price decline, a compensation committee may prefer to use a trailing average closing stock price for the 20 or 30 days (or even longer) preceding the grant date.
    - This approach will create disconnects between the target value of long-term incentives and the accounting value of the awards.
    - Additional employee education is typically needed to explain why the average stock price methodology is a better estimate of value than the stock price on the date of grant.

Pricing RSUs

- For a falling stock price, a company might also consider applying a discount to the long-term incentive award guidelines. If the stock price has fallen from $50 to $30 (or a 40% decline), the company would need to grant 67% more in order to maintain the award target value.
- To mitigate the pressure that this will put on share usage, the company can apply a discount to the target award value that partially adjusts for the impact of the stock price decline. For example, it could discount the award sizes by 25% (a $200,000 award would be reduced to $150,000 and the grant would require 5,000 shares at a $30.00 stock price). This is more than the 4,000 shares that would have been required to deliver $200,000 at a $50.00 stock price but significantly less than the 6,667 shares required to deliver the full $200,000 at $30.00.

RSUs and Equity Incentive Plan Share Counting

- Stock incentive plans and amendments to increase the number of shares available for issuance require stockholder approval under stock exchange rules.
- Large institutional investors, such as Vanguard, Blackrock, State Street, and Fidelity, and shareholder advisory firms, such as ISS and Glass Lewis, can influence approval of an equity incentive plan or amendment. Key issues for these constituents include dilution and burn/usage rate.
- For traditional plans, each RSU granted counts as one share issued under the plan.
- To optimize the number of shares for which a company can request shareholder approval without triggering negative votes or voting recommendations, some equity plans employ a fungible share ratio approach that provides that shares are counted against the plan's share pool based on the type of award being granted. For example, with a fungible share ratio of 2 to 1: (i) each full-value share (such as RSUs) would count as 2.0 shares against the plan's share pool and (ii) each stock option granted would count as a single share against the plan's share pool. This approach reflects the higher value/cost that institutional investors and proxy advisory firms place on full value awards when evaluating a company's stock plan.

RSUs and Stock Incentive Plan Share Counting

- Companies using such an approach must carefully track the number of RSUs granted to ensure they don't exceed plan limits.
- Grants of RSUs that vest based on whether the company or an individual achieves certain performance goals – PSUs – also must be carefully accounted for.
  - Such PSUs could represent a range of potential share issuances based on performance – from zero, to a target amount, to a maximum amount.
  - In considering shares available for grant, companies should reserve against the plan capacity the maximum number of shares issuable in respect of PSUs to avoid exceeding plan limits.
- Some stock incentive plans also place caps on the number of shares that may be granted as full value awards – companies need to closely track progress against such caps.

RSUs and Taxes

- In the U.S., RSUs generally will become taxable upon settlement.
  - Taxable amount is based on the value of the stock on the date the RSUs are settled.
  - For RSUs issued to employees, the value will be treated as taxable compensation subject to withholding.
  - Companies will typically reduce the number of RSUs issued to the employees by a number of shares equal in value to the withholding requirement.
    - Company will then pay the withholding from cash on hand.
    - The withheld RSUs may either be recycled back into the stock incentive plan pool or be retired.*

RSUs and Taxes

- In order to preserve cash, some companies will provide for mandatory sell to cover (where shares are sold in the market on behalf of the employee to cover the tax withholding).
  - Any sell to cover must be carefully implemented to take into account vesting that may occur during blackout periods.
  - Such sales are not exempt under Section 16 and, accordingly, must be carefully monitored for Section 16 officers.
  - Sold shares do not return to the stock incentive plan pool.
- Company can also require employee to pay withholding taxes themselves.

* Recycling withheld shares is considered “liberal share recycling” and generally is viewed negatively by ISS and other shareholder advisory firms. Accordingly, other than recently-public companies, most stock incentive plans do not allow for withheld shares to be recycled.

Inducement Grants

Inducement Grants

- The decline in the price of a company's stock may have a detrimental impact on the company's ability to use equity for compensation.
- When a company's stock price decreases, the company will be required to issue more shares in order to provide the same intended incentive value of equity compensation the company would have granted prior to the decrease in stock price, which may result in a potential shortfall in the number of shares available under existing equity compensation plans.
- Exchange rules typically require a company to obtain shareholder approval prior to adopting equity compensation plans or increasing the number of shares available under existing equity plans.
- Inducement grants to new employees can in limited circumstances be a partial solution because inducement grants do not require shareholder approval.
- NYSE and Nasdaq rules provide that a company may issue inducement grants without shareholder approval by following the requirements in the rules. Nasdaq IM-5635-1 explains that the exception is based, in part, on the fact that the company has an arm's length relationship with the new employees. Nasdaq Rule 5635(c)(4); NYSE 303A.08 of the Listed Company Manual.

Inducement Grants – SEC and Stock Exchange Requirements

- Nasdaq requirements:
  - Grant may only be issued to new hires. A company may not rely on the inducement award exception for a grant made immediately after an individual is hired if grant was not discussed or negotiated in connection with the hiring process, because the grant would not be a material inducement to the individual entering into employment.
  - Press release required promptly following inducement grant:
    - Disclose material terms of the inducement grant, including the recipient(s), and the number of shares.
    - “Promptly” = four days
    - Nasdaq rule requires a press release; Form 8-K in lieu of a press release is not permitted.
  - Inducement grants not available to directors or current employees.

Inducement Grants – SEC and Stock Exchange Requirements

- Stock exchange rules permit aggregated disclosure for (1) routine inducement grants to new employees under a program in which equity grants are made without individual negotiation, and (2) inducement grants made to employees of a target company in connection with a merger or acquisition, other than grants made to executive officers of the post-merger company.
- Issuance of shares must be registered on Form S-8.
- A Form S-8 previously filed with the SEC will not cover the issuances of shares outside of existing equity compensation plans. The company must file a new Form S-8 for inducement grant shares. The Form S-8 can cover an individual inducement award or an inducement award program.
- The company also must submit a listing application to the exchange.
  - NYSE – requires listing application no later than the public announcement and prior to the issuance of the shares.
  - Nasdaq – requires submission of a notice of listing of additional shares by the earlier of five days after entry into the agreement to issue the shares, or the date of the public announcement.

Winding Down

Securities Law Aspects of Winding Down

- Securities law issues to consider when winding down:
  - Form 8-K (Item 3.01 – notice of delisting and Item 8.01 – announce winding down)
  - Notification to the stock exchange of intent to voluntarily delist the company's shares, if applicable
  - Consider whether to issue press release or just file Form 8-K
  - File Form 25 with the SEC to effect the delisting under Section 12 of the Exchange Act. Removal of the class of securities from listing becomes effective 10 days after filing.
  - File Form 15 with the SEC after the Form 25 becomes effective.
  - Refer to the "Going Dark" slides for further information about delisting and deregistration.

Non-GAAP Adjustments

Non-GAAP Adjustments

- Non-GAAP financial measures are measures of performance or liquidity that are alternatives to GAAP, and that include GAAP amounts that are excluded from (or exclude amounts that are included in) the most directly comparable GAAP measure.
- Companies use non-GAAP financial measures to supplement their financial statements to better present management's view of the company's business to investors and analysts. During volatile markets, companies may want to use non-GAAP financial measures to better explain various performance and liquidity measures.
- Companies may use non-GAAP measures to show investors management's view of the company's core operations, typically by eliminating nonrecurring charges and other amounts they believe are not indicative of their ongoing performance.

Non-GAAP Adjustments – SEC Staff Review

- SEC staff will review filings such as Form 10-K, Form 10-Q and Form 8-K reports for compliance with SEC rules, but also review unfiled documents and information such as earnings releases, investor presentations, and other information posted on the company's website.
- Common themes in recent SEC comments:
  - Prominence: presentation with equal or greater prominence of most directly comparable GAAP measure, including in headlines and tables;
  - Reconciliation to the most directly comparable GAAP financial measure;
  - Appropriateness of certain adjustments to eliminate or smooth items identified as non-recurring, infrequent or unusual;
  - Use of individually tailored accounting principles; and
  - Disclosure of why management believes that a non-GAAP financial measure provides useful information regarding the company's financial condition or results of operations, and, when required, how management uses the non-GAAP financial measure.

Non-GAAP Adjustments – Applicable Rules

- **Regulation G** – Applies to any public disclosures, even if not in SEC filings and not written (e.g., investor presentations), and requires:
  - Presentation cannot be misleading;
  - Presentation of most directly comparable GAAP metric; and
  - A reconciliation of each non-GAAP measure to the most directly comparable GAAP measure.
- **Item 10(e)(1) of Regulation S-K** – Applies to all SEC filings and Item 2.02 of Form 8-K (including earnings releases), and requires:
  - Presentation of most directly comparable GAAP measure with equal or greater prominence than non-GAAP metric;
  - Quantitative reconciliation of each non-GAAP measure to the most directly comparable GAAP measure;
  - Disclosure of why management believes the non-GAAP metric is useful to investors; and
  - To the extent material, disclosure of any additional purposes for which the company uses the non-GAAP measures.
  - The last two bullets above may be satisfied by including the statements in the relevant (1) earnings release, (2) Form 8-K, or (3) most recent Form 10-K or more recent SEC filing, with any necessary updating.

Non-GAAP Adjustments – Applicable Rules

- SEC staff has provided important guidance in Non-GAAP Financial Measures CDIs (2016). Review prior to making adjustment or presenting a new measure.
- SEC Enforcement action in 2018 against ADT, Inc. for presenting non-GAAP financial measures in the headlines to its earnings releases, without giving the comparable GAAP financial measures equal or greater prominence in the headline. ADT presented adjusted EBITDA in the headline without disclosing net income or loss, the comparable GAAP financial measure, in the headline. See ADT Inc. order.

Non-GAAP Adjustments - Prohibitions

- Item 10(e)(2) of Regulation S-K prohibits a company from doing the following:
  - Adjusting a non-GAAP measure to eliminate or “smooth” items as non-recurring, infrequent or unusual, if the charge or gain is reasonably likely to recur within two years, or if there was a similar charge or gain the prior two years.
  - Excluding from non-GAAP liquidity measures (other than EBITDA and EBIT) any charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner.
  - Presenting non-GAAP measures on the face of the company’s GAAP financial statements or in the accompanying notes.
  - Using titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP measures.
  - Presenting non-GAAP measures on the face of any pro forma financial information required to be disclosed by Regulation S-X, Article 11.

Thank You