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# Alert | Corporate

**October 2018**

# NASDAQ Provides Additional Flexibility Under Its 20% Shareholder Approval Rule

Effective Sept. 26, 2018, the Securities and Exchange Commission (SEC) approved amendments to Nasdaq's shareholder approval rule regarding issuances of 20% or more of an issuer's outstanding common stock or voting power in a private offering. The amendments are intended to update Nasdaq's shareholder approval rules from their 1990 adoption and enhance the ability for capital formation without sacrificing investor protections. In short, the amendments eliminate book value, and modify the market value measure to include a five-day average and use the closing price instead of the closing bid price.

The "20% rule," as it is commonly known, requires Nasdaq and NYSE-listed companies in certain situations to receive shareholder approval before they can issue 20% or more of their outstanding common stock or voting power in a private offering, such as a PIPE (private investment in public equity). Nasdaq and the NYSE also require shareholder approval in connection with the issuance of securities that will result in a change of control, certain acquisition-related issuances, and issuances of securities involving equity compensation. Nasdaq is not amending these other shareholder approval provisions.

## What is the Purpose of the 20% Rule?

Follow-on offerings of securities of an issuer are potentially dilutive to existing shareholders, and offerings of 20% or more of an issuer's securities at discounted prices may be meaningfully dilutive. In addition, existing shareholders are rarely allowed to participate in these offerings because of their private nature. As a result, the 20% rule is designed to provide shareholders with adequate notice and disclosure of the proposed private offering so that they have an opportunity to sell their securities or vote on the proposed private offering.

## Summary of Changes to Nasdaq's 20% Rule

The amended Rule 5635(d) provides that "shareholder approval is required prior to a 20% Issuance at a price that is less than the Minimum Price." The amendments simplify the 20% Rule by:

- modifying the measure of market value to use the lower of closing price or the five-day average closing price rather than using the closing bid price; and
- eliminating the book value test.

*20% Issuance*

Nasdaq defines "20% Issuance" for purposes of Rule 5635(d) as a private placement transaction involving the sale, issuance, or potential issuance by the issuer of common stock (or securities convertible into or exercisable for common stock), which, alone or together with sales by officers, directors, or Substantial Shareholders (persons with more than 5% of the number of securities or voting power outstanding) of the issuer, equals 20% or more of the common stock or 20% or more of the voting power outstanding before the issuance. This definition combines the existing provisions of Rule 5635(d)(1) and (d)(2) into one provision. This revision does not make any substantive change to the threshold for quantity or voting power of securities being sold that would give rise to the need for shareholder approval, although, as described below, the applicable pricing test has changed.

*Changes to Measure Market Value as the Lower of Closing Price or Five-Day Average Closing Price*

As amended, Nasdaq modified the market value measure to reference the Minimum Price rather than the closing bid price. Minimum Price is defined as the price that is the **lower of** (1) the closing price (as reflected on Nasdaq.com) immediately preceding the signing of the binding agreement or (2) the average closing price of the common stock (as reflected on Nasdaq.com) for the five trading days immediately preceding the signing of the binding agreement. In using the closing price, rather than the closing bid price as under the prior rule, Nasdaq explained that the closing price reported on Nasdaq.com is the Nasdaq official closing price, reflects actual sale prices at one of the most liquid times of day, better reflects market price, is highly transparent to investors, and is consistent with the approach of the NYSE. In addition, Nasdaq noted that the five-day average closing price is a reasonable alternative for measuring market value given the impracticality of assessing market value as of a specific time and could be a fairer indicator of value of the securities than closing bid prices, which are prone to unanticipated market fluctuations. Accordingly, an issuance of securities would not require shareholder approval if the issuance occurs at a price greater than the lower of the two measures.

*Elimination of Book Value Test*

Nasdaq also eliminated, in conjunction with its proposal to redefine market value for purposes of determining when a shareholder vote is triggered under Rule 5635(d), the prior requirement for shareholder approval of private placement issuances at a price that is less than book value. Prior to the amendment, Nasdaq's rules required shareholder approval of a private placement transaction if it was priced below market or book value. Nasdaq recognized that book value is not an appropriate measure of whether a transaction is dilutive or should otherwise require shareholder approval. As a result, Nasdaq's rules now provide that private placement transactions that are priced below book value but above market value – as defined by the Minimum Price – would not require shareholder approval.

### Other Shareholder Approval Provisions Still Applicable

The ability of listed companies to issue securities in private placements without shareholder approval remains limited by other important Nasdaq rules. For example, any discounted issuance of securities to a company's officers, directors, employees, or consultants would require shareholder approval under Nasdaq's equity compensation rules. In addition, shareholder approval would be required if the issuance resulted in a change of control and for the acquisition of stock or assets of another company, including where an issuance increases voting power or common stock by 5% or more and an officer or director or substantial security holder has a 5% direct or indirect (or collectively 10%) interest in the company or assets to be acquired. In particular, the term "Market Value" in Nasdaq Rule 5005(a)(23), which is defined as the consolidated closing bid price multiplied by the measure to be valued (e.g., a company's market value of publicly held securities is equal to the consolidated closing bid price multiplied by a company's publicly held securities), will still be applicable to these shareholder approval rules as well as other listing rules. Nasdaq amended the definition of "Market Value" only for purposes of the 20% Rule.

Finally, be mindful that Rule 5250(e), among other things, requires 15 days advance notice prior to issuing common stock or securities convertible into common stock greater than 10% of the total securities outstanding.

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Although these changes provide greater clarity to Nasdaq-listed companies regarding the appropriate price to use in determining whether shareholder approval is required to issue 20% or more of their outstanding securities or voting power in a private placement transaction, listed companies should still identify early in the transaction process whether the shareholder approval rules will be implicated so that they may structure the transaction in a way to potentially avoid the shareholder approval rules. Nevertheless, these changes will hopefully relieve some of the challenges issuers face in an intraday PIPE offering. Fortunately, as part of these changes, Nasdaq did not 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 as it had proposed back in June 2017.

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