Expert Analysis

Nasdaq's New 20% Rule Is Good For Listed Companies

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The U.S. Securities and Exchange Commission has approved amendments to Nasdaq's shareholder approval rule regarding issuances of 20 percent or more of an issuer's outstanding common stock or voting power in a private offering. Intended to update Nasdaq's shareholder approval rules from their 1990 adoption and enhance the ability of capital formation without sacrificing investor protections, these changes provide greater clarity and flexibility to Nasdaq-listed companies regarding the appropriate price to use in determining whether shareholder approval is required to issue 20 percent or more of their outstanding securities or voting power in a private placement transaction.

The "20 percent rule," as it is commonly known, requires Nasdaq- and New York Stock Exchange-listed companies in certain situations to receive shareholder approval before they can issue 20 percent or more of their outstanding common stock or voting power in a private offering, such as a private investment in public equity, or PIPE. 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.

The amendments, which became effective on Sept. 26, eliminate book value as the minimum price for certain permitted offerings, and modify the market value measure in the rule to use the lower of the closing price or five-day average closing price, instead of the closing bid price. The amended 20 percent rule will provide issuers greater flexibility in structuring their transactions by allowing them to account for market volatility and one-off events that can create an artificially high or low price. For example, these changes will hopefully relieve some of the challenges issuers face in an intraday PIPE offering. Companies should take note that fortunately, as part of these changes, Nasdaq did not require that an issuance of 20 percent 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.

Nasdaq's 20 percent rule — Rule 5635(d) — serves an important purpose. Follow-on offerings of securities of an issuer are potentially dilutive to existing shareholders, and offerings of 20 percent 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 percent 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.

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 percent rule by modifying the measure of market value to use the lower of the closing price or the five-day average closing price rather than using the closing bid price, and by eliminating the book value test. Companies should also 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 percent of the total securities outstanding.

Nasdaq defines "20 percent 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 percent of the number of securities or voting power outstanding) of the issuer, equals 20 percent or more of the common stock or 20 percent 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, though the applicable pricing test has changed.

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 the 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.

The amendments also eliminate what's known as "book value test." In conjunction with its proposal to redefine market value for purposes of determining when a shareholder vote is triggered under Rule 5635(d), Nasdaq eliminated 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.

Companies should be mindful that other shareholder approval provisions are 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 percent or more and an officer or director or substantial security holder has a 5 percent direct or indirect (or collectively 10 percent) 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 percent rule.

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