Life Sciences/Securities Advisory

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JUNE 1, 2011

Important Factors That May Affect the Size of Your Financing Transaction

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The need to raise capital in the public equity markets is an ongoing fact of life for many, if not most, publicly traded life science companies. Indeed, having access to the public markets to help finance research and development is one of the principal benefits of going public. In pursuing such financings, companies must be aware of certain rules and regulations promulgated by the securities exchanges[1] and by the Securities and Exchange Commission (SEC) that can limit the size of financing transactions. By understanding and addressing these rules in advance, companies can seek to structure a financing transaction in a manner that can maximize the amount of funds that can be raised.

The two rules we will be addressing in this advisory are as follows:

1. **NASDAQ Listing Rule 5635(d) (the NASDAQ 20% Rule)**, which requires shareholder approval of a transaction other than a public offering involving the sale, issuance, or potential issuance by a company of common stock (or securities convertible into or exercisable for common stock) equal to 20% or more of the common stock, or 20% or more of the voting power outstanding before the issuance for less than the greater of book or market value of the stock.

2. **General Instruction I.B.6 to Form S-3 (the Baby Shelf Rules)**, [2] which provides that a registrant with a market value of common equity held by non-affiliates (the public float) of less than $75 million may only sell under a Form S-3, during any 12-month period, securities having an aggregate market value of not more than one-third of the public float of such registrant.

The NASDAQ 20% Rule

As noted above, the NASDAQ 20% Rule requires shareholder approval of a transaction **other than a public offering** involving the sale, issuance, or potential issuance by a company of common stock (or securities convertible into or exercisable for common stock) equal to **20% or more of the common stock or 20% or more of the voting power** outstanding before the issuance for less than the **greater of book or market value** of the stock. If not properly addressed, this rule can significantly limit the funds a NASDAQ-listed issuer can raise in a financing transaction. The following questions/answers will help you understand how this rule works:

What is a "public offering" for purposes of this rule?

NASDAQ has never provided a bright-line definition of what constitutes a "public offering" for purposes

of this rule. Importantly, however, even though a transaction is to be effected as a registered offering under the Securities Act of 1933, e.g., a takedown off a Form S-3 shelf registration statement, that fact is not dispositive from NASDAQ's perspective. Generally, NASDAQ will look to the extent and type of marketing effort involved in the offering. A broadly marketed offering that is publicly announced prior to its pricing will usually be fine, whereas an offering that is marketed to a limited number of institutional investors will not be. NASDAQ has stated that "[g]enerally, a firm commitment underwritten securities offering registered with the Securities and Exchange Commission will be considered a public offering for these purposes." [3] However, even a firm commitment underwritten offering, if marketed to only a small number of institutions, will not be a public offering for purposes of the NASDAQ 20% Rule.

How is the 20% limit calculated?

The 20% limit is calculated on a pre-transaction basis. For example, if a company had 10,000,000 shares of common stock outstanding (and no other outstanding voting stock), a company could issue no more than 1,999,999 shares in an offering that was not deemed by NASDAQ to be a public offering at below the greater of book or market value, without shareholder approval. It is very important to note that NASDAQ will count any shares that could possibly ever be issued in connection with the transaction in calculating whether the 20% threshold has been crossed.

Accordingly, a company must be very careful in evaluating the effects of any anti-dilution provisions or "price reset" [4] provisions, which may be included in the terms of the deal. For example, if a convertible security has full ratchet anti-dilution protection for the investors, without a floor on the price at which the conversion price can be reset, NASDAQ will assume the worst case scenario (i.e., that the conversion/exercise price will be reset to $0.01 per share) and will calculate the number of shares potentially issuable based on a conversion/exercise price of $0.01 per share. Similarly, if a transaction has a "price reset" provision, NASDAQ will calculate the number of shares potentially issuable based on the lowest possible price. In addition, if a transaction includes warrant coverage, unless the warrants are structured a certain way (see below), the shares issuable upon exercise of the warrants will be counted toward the 20%.

How are book value and market value calculated?

Under NASDAQ rules, "market value" is the consolidated closing bid price[5] immediately preceding the entering into of the binding agreement to issue the securities. Accordingly, if the binding agreement is entered into during market hours (i.e., before 4:00 pm Eastern Time), the previous trading day's consolidated closing bid price is used. If the agreement is entered into after the close of the regular session, then that day's consolidated closing bid price is used. "Book value" is the common stockholders' equity from the company's most recent public filing with the SEC. Book value per share is the common stockholders' equity divided by the total shares outstanding.

What can we do to structure our transaction to comply with the NASDAQ 20% Rule?

If the financing as contemplated would not result in the issuance or potential issuance of more than 20% of the company's outstanding common stock, you have no concerns under the NASDAQ 20% Rule. If, however, you anticipate that in order to raise the funds desired you might exceed the 20% cap, there are ways that the transaction can be structured to avoid having to obtain shareholder approval under the NASDAQ 20% Rule and allow you to maximize the funds to be raised.

Structure the offering as a "public offering."

Because the NASDAQ 20% Rule applies only to "transactions other than a public offering," if the transaction is structured as a public offering, the rule does not apply. As noted above, NASDAQ has steadfastly declined to set out specific parameters for what it would deem to be a public offering. It is

clear that an offering, whether or not it is registered, that is marketed to a limited number of institutional investors will not be deemed to be a public offering by NASDAQ. On the other hand, it is clear that a publicly announced underwritten offering, followed by a broad marketing effort (including a retail component) will pass muster under this rule.

Many companies, however, are hesitant to structure a financing as a publicly announced offering because the announcement of the offering often will result in significant downward pressure on the stock price prior to the pricing of the offering. In addition, if a company's public announcement is followed by a less-than-successful marketing effort, the deal can be seen as a weak endorsement of the company by the market. As a consequence, many investment banks now structure certain offerings as what have become known as confidentially marketed public offerings (CMPOs). In a CMPO, the investment bank will market an offering over the course of a few days to a limited number of institutional investors under confidentiality agreements. If, based on this limited marketing effort, the bank deems that there is enough interest in the company's stock to complete a "public offering," the bank and the company will decide to "flip" the offering, and, immediately following market close on a particular trading day, the offering will be announced via press release and/or the filing of a preliminary prospectus. The bank will then conduct a brief but broad and intensive marketing "blitz" over the course of the evening and night. The offering is then priced and final terms are announced prior to market open the following day. Because of the public announcement of the offering followed by the broad marketing effort of the bank, NASDAQ has permitted such "flipped" offerings to qualify as public offerings.

Structure the warrant coverage so that the warrant shares do not count toward the 20% limit.

As noted above, in calculating whether an offering constitutes the issuance or potential issuance by a company of common stock (or securities convertible into or exercisable for common stock) equal to 20% or more of the common stock or 20% or more of the voting power outstanding, NASDAQ will count every share that could ever possibly be issued in connection with the transaction. Accordingly, shares issuable upon the exercise of warrants and other convertible securities are generally counted when determining if the 20% threshold has been crossed. If, however, a company is engaged in a common stock/warrant offering, and the number of shares of common stock being issued is less than 20%, but when the warrant shares are aggregated with the common stock to be issued, the 20% threshold will be exceeded, it is possible to structure the warrants in a way so that they are not counted toward the 20% cap. NASDAQ has stated that the warrant shares will not be aggregated if the warrants (1) are not exercisable for at least six months following closing, and (2) are not exercisable for less than the greater of book or market value of the common stock on the date of the binding agreement to issue the securities. Accordingly, if the warrants are structured appropriately, the offering size can be maximized without violating the rule.

Structure the deal so that it is priced at "market value."

If the number of shares of common stock (or common stock equivalents) being issued by itself exceeds the 20% limit (or if the investors do not agree to structure the warrants as set forth above and the aggregate of the common stock and warrant shares exceed 20%), shareholder approval is not required if the deal is priced at "market value." [6] When calculating whether or not a transaction is effected at market value, it is very important to note that if warrants are also issued in the transaction, NASDAQ attributes a value of $0.125 (plus any amount that the warrant is in the money) to each warrant share.

For example: A company with a market value of its common stock of $5.00 per share proposes to issue units consisting of one share of common stock and a warrant to purchase 0.5 of a share of common stock (with an exercise price above market value). For each unit, there is a half of a warrant share to which NASDAQ will attribute a value of 0.5 x $0.125 = $0.0625. Accordingly, in order for the transaction to be considered a market value transaction, the price per unit must be at least $5.00 + $0.0625 = $5.0625. This is without regard to whether the warrants are immediately exercisable.

Can we close a deal now and get shareholder approval later?

One way to close a transaction and defer shareholder approval until a later date is to use a "share cap." A share cap is a contractual or charter provision that "caps" or limits the number of shares that can be issued in a transaction, such that there cannot be an issuance of 20% or more of the common stock or voting power without prior shareholder approval. This often results in there being two closings as part of the transaction: one closing for the issuance of 19.9% of a company's outstanding shares, and a second closing following receipt of shareholder approval at which the remaining shares are issued. NASDAQ allows the use of such share caps, but has provided the following guidance with respect thereto:

- Shares issued by a company in the first closing of the transaction (i.e., the shares issued under the cap) are not entitled to vote at the shareholder meeting to approve the remainder of the transaction.
- The share cap must apply for as long as the security is outstanding (or until subsequent shareholder approval). For example, a share cap that only applies for as long as the company is listed on NASDAQ is not acceptable.
- Share caps that have "alternative outcome clauses" (i.e., a "penalty" or "sweetener") depending on the outcome of the shareholder vote are not acceptable. NASDAQ has provided the following examples of unacceptable alternative outcomes:
    - in a debt security, the indenture provides for the interest rate to increase or decrease based on whether shareholders do or do not approve the transaction;
    - a provision requiring redemption of the securities if shareholders do not approve the transaction; or
    - a provision reducing the conversion rate of a convertible security if shareholders do not approve the issuance.

Are there any other NASDAQ rules we should be aware of or concerned about?

Pursuant to NASDAQ Listing Rule 5635(c), shareholder approval is required prior to the issuance of securities pursuant to an equity compensation arrangement with officers, directors, employees, or consultants. NASDAQ has taken the position that the issuance of stock by a NASDAQ-listed issuer to its officers, directors, employees, or consultants, or an "affiliated entity" [7] in a **private placement at a price less than the market value** of the stock is considered a form of "equity compensation" and requires shareholder approval. Accordingly, if any of your officers, directors, employees, or consultants want to purchase shares in an offering, you must make sure that either (1) the transaction is structured as a public offering (see above) or (2) the transaction is priced at market value (see above).

In addition, pursuant to NASDAQ Listing Rule 5635(b), shareholder approval is required prior to the issuance of securities when the issuance or potential issuance will result in a "change of control" of the company. Generally NASDAQ deems a change of control to have occurred when, as a result of the issuance, an investor owns, or has the right to acquire, 20% or more of the outstanding shares of common stock or voting power and such ownership or voting power would be the largest ownership position in the company. Accordingly, you need to be careful not to inadvertently trigger a shareholder approval requirement by issuing a large block of stock to one investor such that a change of control would occur.

The Baby Shelf Rules

Prior to the SEC's amendments to Form S-3 in January 2008, companies with a market value of

common equity held by non-affiliates (i.e., public float) of less than $75 million could not use Form S-3 for primary offerings of their shares. In January 2008, however, the SEC amended Form S-3 and added what have come to be known as the "Baby Shelf Rules." Under the Baby Shelf Rules, a registrant with a public float of less than $75 million may sell, under a Form S-3, during any 12-month period, securities having an aggregate market value of not more than one-third of the public float of such registrant. The following questions/answers will help you understand how this rule works:

When is the public float measured for purposes of determining if we are limited by the Baby Shelf Rules?

Whether a company is limited in the amount it can sell under Form S-3 because of a public float of less than $75 million is initially determined at the time the S-3 registration statement is filed with the SEC. If the company's public float was at least $75 million at any time within 60 days prior to the filing date of the Form S-3, there is no limitation initially. This standard is, however, reassessed every time the company files a Form 10-K. Accordingly, even if the S-3 is filed when the company has a public float equal to or greater than $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 Rules going forward until such time as the public float exceeds $75 million again.[8]

How is public float calculated?

Public float" is the aggregate market value of the voting and non-voting common equity held by non-affiliates of the company, and is simply calculated by multiplying the number of shares held by non-affiliates by the "market value" of the common equity. Under the SEC's rules for "market value," you can use either the closing sale price or (the average of the last bid and last ask prices of the common equity as of any date within 60 days prior to (1) the filing of the Form S-3 or Form 10-K (if you are computing whether a company has a $75 million public float) or (2) the date of sale (if you are selling securities from an already-effective Form S-3 and are determining the amount that is available to sell under the Baby Shelf Rules). It is important to note that you need not use the same date for determining the number of shares held by non-affiliates and the market value of the common equity. For example, you could calculate the number of shares held by non-affiliates as of the date of filing or date of sale and use some other date within 60 days to determine market value.

What happens if our public float is less than $75 million at the time we file the Form S-3 or the Form 10-K, but goes above $75 million thereafter?

When a Form S-3 is filed (or when a subsequent Form 10-K is filed), if the public float was not at least $75 million within 60 days prior to the filing, the company is limited in the amount it can sell under the Baby Shelf Rules—only until such time as the public float exceeds $75 million again. Accordingly, if after the filing, the public float exceeds $75 million at any time, the company is no longer limited in the amount of securities it can sell under Form S-3 until the public float is reassessed at the time of filing of the next Form 10-K.

For example, assume a calendar year-end company with an effective shelf S-3 filed its Form 10-K on March 14, 2011, and its highest public float within 60 days of the filing was $60 million. This company is limited under the Baby Shelf Rules. Now assume that there is an increase in the stock price and as of May 1, 2011, the public float has increased to $80 million, but a week later the stock falls to previous levels and the public float is back to $60 million. As of May 1, 2011, this company is no longer limited in the amount of securities it can sell under Form S-3, even though its public float is again less than $75 million. Of course if the public float remains below $75 million when it files its Form 10-K in March 2012 (i.e., its public float is not at least $75 million within 60 days prior to the filing of the Form 10-K), the Baby Shelf Rules limitation will again apply.

How do we calculate the value of securities we can sell under this rule?

An analysis of the amount of securities that may be sold under the Baby Shelf Rules involves a three-step process, as follows:

1. Determination of the highest public float within 60 days of the offering.
2. Calculation of one-third of such public float.
3. Calculation of the market value of securities sold under a Form S-3 pursuant to the Baby Shelf Rules within the 12 months preceding the date of sale of securities, including the market value of the securities contemplated to be sold in the current offering, to determine that the one-third limit is not exceeded.

The easiest way to explain such an analysis is through an illustration. Assume a stock/warrant offering by a company that has (1) 24,000,000 shares of common stock held by non-affiliates and (2) a highest closing stock price within 60 days prior to the offering of $1.50 per share. Also assume the stock is sold in the offering at $1.25 per share, and there is 50% warrant coverage with an exercise price of $1.40 per share (which is the current market value). The company has not sold any other securities pursuant to the Baby Shelf Rules within the last 12 months.

1. The public float is calculated at $36 million, based on 24,000,000 shares held by non-affiliates and a highest closing price of $1.50 per share within the past 60 days.
2. One-third of the public float is $12 million.
3. The value of the stock offered is calculated based on the sale price (i.e., $1.25 per share). Under SEC rules, however, the value of the warrant shares is not based on either the sale price of the stock or the exercise price of the warrant, but as a derivative security, the value is based on the per share price that the company used to calculate the public float (i.e., $1.50 per share). Accordingly, based on a maximum value of securities that can be sold of $12 million (i.e., one-third of the public float), the number of shares that can be sold is calculated using the following equation, solving for X as the number of shares:

$$X(\$1.25) + .5X(\$1.50) = \$12{,}000{,}000$$

$$X = 6{,}000{,}000$$

Accordingly, this company can sell 6,000,000 shares at $1.25 per share and warrants to purchase 3,000,000 shares at an exercise price of $1.40 per share. [9]

Please contact the Mintz Levin attorney who handles your securities compliance matters if you have any questions regarding these rules or related matters.

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Endnotes

1 This advisory will focus on the rules and regulations promulgated by The NASDAQ Stock Market. Please note, however, that almost all national securities exchanges have analogous rules. If your company is listed on an exchange other than NASDAQ, please contact the Mintz Levin attorney who handles your securities compliance matters for information about other exchanges' requirements.

2 For foreign private issuers, the analogous rule is General Instruction I.B.5 to Form F-3.

3 See NASDAQ Listing Rules, IM-5635-3.

4 A "price reset" provision is a provision pursuant to which the price at which stock has been issued or at which

convertible securities convert may be “reset” downward at a future date if the stock price is lower as of such date, resulting in the issuance or potential issuance of more shares.

5 To obtain the consolidated closing bid price, companies may call their representative at NASDAQ’s Market Intelligence Desk. In addition, this information can be obtained by calling the Market Intelligence Desk at 646-344-7800 or by calling NASDAQ MarketWatch at 1-800-537-3929. NASDAQ recommends that when you are requesting this information, be sure to specify the “consolidated” closing bid price.

6 This assumes that market value is greater than book value.

7 An “affiliated entity” is any entity where an officer, director, employee, or consultant of the company (1) is a partner, executive officer, or controlling shareholder, or (2) would be the beneficial owner of or have a pecuniary interest in the securities issued by the company.

8 Note that primary shelf registration statements are only effective for three years from the initial date of effectiveness, after which a new Form S-3 filing must be made. If a new primary shelf Form S-3 has been filed prior to the expiration date of an existing primary shelf Form S-3, the existing Form S-3 can continue to be used for up to six months after its expiration date in order to allow for the resolution of any comments on the new Form S-3.

9 PLEASE NOTE: Depending on the total number of shares that this issuer has outstanding, it may also need to take into account the application of the NASDAQ 20% Rule as noted above.

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1162-0511-NAT-SEC