Top 10 Practice Tips: Registered Direct Offerings

A Practical Guidance® Practice Note by
Anna Pinedo and Ziv Schwartz, Mayer Brown LLP

Anna Pinedo
Mayer Brown LLP

Ziv Schwartz
Mayer Brown LLP

This Top 10 practice tips provides practical guidance for counsel working on a registered direct offering (RDO). An RDO is a public offering of securities sold on a best efforts basis by a placement agent engaged by an issuer to introduce the issuer to potential investors. An RDO is generally targeted to a select number of accredited and institutional investors, although it may be sold to non-accredited investors. Issuers find RDOs an attractive option when they are seeking to test the market or conduct an offering without attracting much market attention.

1. **Understand the benefits of an RDO.** RDOs are private style public offerings that have characteristics of both public and private offerings. An RDO is a placement of registered securities pursuant to an issuer's effective registration statement and the securities are freely transferable. RDOs are generally sold to a limited number of institutional investors; however, as an RDO is a public offering, it can also be made to retail investors. An RDO's targeted marketing, similar to the marketing approach employed in a private placement or a private investment in public equity (PIPE) transaction, makes it attractive to issuers that want to test the market or conduct an offering without attracting publicity. When an issuer has an effective shelf registration statement, the placement agent may market a potential RDO by obtaining confidentiality undertakings and approaching investors on a wall-crossed basis until an actual transaction is announced. This confidential marketing allows an issuer to test the market without exposing its stock to speculative trading that often accompanies a fully marketed follow-on offering. The issuer announces the transaction immediately prior to or at pricing of the RDO. In addition, an RDO allows an issuer to obtain public offering pricing with no liquidity discount while maintaining the relative confidentiality of a private placement because investors receive registered securities. To the extent that the issuer is seeking a more broadly marketed offering, an RDO may not be the best choice.
2. **Ensure that the board of directors and the pricing committee understand the structure of the RDO.** An RDO is a best efforts placement of securities. The placement agent will not be required to purchase, and cannot purchase, any of the offered securities and thus will not need to use its capital. In addition, the placement agent cannot engage in market stabilizing transactions in connection with the RDO and can only engage in passive market making activities. An RDO does not include an over-allotment option, which is principally used for market stabilization in connection with firm commitment offerings and is not applicable to an RDO. To meet additional demand, an issuer can increase the RDO's size. However, the issuer should

understand that, to the extent its stock is volatile, the placement agent can neither engage in stabilization activities nor exercise an over-allotment option for this or any other purpose.

3. **Consider the best structure for the RDO and whether an escrow account is required.** An RDO can be structured in any of the following ways: (1) on an all or nothing basis, in which case all the offered securities must be sold for the transaction to close; (2) on a minimum/maximum basis, in which case a minimum number of securities must be sold or minimum dollar amount must be raised for the transaction to close; or (3) on an any or all basis, in which case the transaction will close without any minimum threshold having been attained. In the case of (1) or (2), Rule 15c2-4 (17 C.F.R. § 240.15c2-4) under the Securities Exchange Act of 1934, as amended, requires the placement agent to set up an escrow account into which investor funds are deposited and held until the conditions for release are met. An issuer may sell shares for its own account, and stockholders may sell their shares, either alone or with issuer's shares, in an RDO.
4. **Registration statement and prospectus supplement.** An RDO is most efficient when the issuer already has an effective shelf registration statement, since, as noted above, one of the compelling attributes of an RDO is the targeted marketing. In such case, the issuer will file a preliminary and/or final prospectus supplement for the RDO. But an issuer can also file a new bullet registration statement, that is a single-purpose registration, or a shelf registration statement, for an RDO. Once the registration statement is effective, the issuer will file a prospectus or, in the case of a shelf, a prospectus supplement for the RDO.
5. **Negotiate the placement agency agreement.** An issuer and the placement agent(s) will enter into a placement agency agreement, which is the equivalent of an underwriting agreement in a firm commitment underwritten offering. The placement agency agreement generally contains the following provisions: (1) exclusive retention of the placement agent to introduce investors on a best efforts basis; (2) issuer representations and warranties; (3) issuer covenants; (4) indemnification of placement agent and certain of its affiliates from liabilities arising in connection with the offering under the Securities Act of 1933, as amended (Securities Act); (5) the requirements for closing deliverables, including legal opinions, 10b-5 negative assurance letter from issuer's counsel, and an auditor comfort letter; and (6) other customary closing certificates. To the extent that the issuer has undertaken an underwritten public offering in close proximity to the proposed RDO, the issuer representations and warranties and the covenants contained in the underwriting agreement from the prior offering may provide a good starting point for the draft placement agency agreement.
6. **Consider whether subscription agreements will be required.** An RDO generally will not involve individual purchase agreements, or subscription agreements, between the issuer and the purchasers. In certain cases, however, hedge fund investors may request a separate agreement with the issuer or to be added as a named third-party beneficiary to the placement agency agreement to receive the benefit of the issuer's representations and warranties in the agreement. If subscription agreements are used in an RDO, the issuer must ensure that such any such agreement is not deemed to constitute an offering-related document, such as a free writing, and that it is not executed prior to the delivery of a prospectus that complies with Section 10 of the Securities Act (15 U.S.C. § 77j). There has been an increase in the number of direct placements undertaken by microcap and small cap issuers to single or multiple investors pursuant to shelf takedowns. In these circumstances, issuers should consider carefully how the purchase commitment with investors is documented.
7. **Consider whether the RDO is a public offering or whether it is subject to the securities exchange 20% rule.** If an issuer anticipates the offering amount in an RDO will exceed 20% of the total pre-transaction shares outstanding and such shares are to be sold at a discount, the issuer must assess whether the applicable securities exchange rules will require shareholder approval.

   Under New York Stock Exchange (NYSE) Rule 312.03(c), shareholder approval is required prior to the issuance of common stock (or securities convertible into or exercisable for common stock) if the common stock has, or will have upon issuance, voting power equal to or in excess of 20% of the voting power outstanding before the issuance, or the number of shares of common stock to be issued is, or will be upon such issuance, equal to or in excess of 20% of the number of shares of common stock outstanding before such issuance. The rule applies unless (1) the offering is a public offering for cash or (2) the financing involves a sale for cash of common stock or securities convertible into or exercisable for common stock, at a price at least as great as the minimum price (i.e., a price that is the

lower of (i) the official NYSE closing price immediately preceding the signing of the binding agreement or (ii) the average official NYSE closing price for the five trading days immediately preceding the signing of the binding agreement), provided that, if the securities in such financing are issued in connection with an acquisition of the stock or assets of another company, shareholder approval will be required if the issuance of such securities alone. or when combined with any other present or potential issuance of common stock or securities convertible into common stock in connection with such acquisition, is equal to or exceeds either 20% of the number of shares of common stock or 20% of the voting power outstanding before the issuance.

Similarly, Rule 5635(d) of The Nasdaq Stock Market (Nasdaq) Rules requires shareholder approval prior to an issuance, other than in a public offering, 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 at a price that is less than the minimum price (which is defined as in the NYSE rule but using the Nasdaq closing price(s)).

An offering for purposes of these shareholder approval rules will not be treated as a public offering merely because it is registered with the Securities and Exchange Commission (SEC). When determining whether an offering is a public offering under these rules, the exchange staff considers all relevant factors, including but not limited to (1) the type of offering (i.e., an underwritten firm commitment offering or a best efforts/agency offering); (2) the manner in which the offering is marketed, including the number of investors offered securities, how those investors were identified, and the breadth of the marketing effort; (3) the extent of the offering's distribution (including the number and identity of the investors participating in the offering and whether any prior relationship existed between the issuer and those investors); (4) the offering price (including the extent of any discount to the market price of the securities offered); and (5) the extent to which the issuer controls the offering and its distribution.

8. **Baby shelf rules and concurrent private placement.** An issuer with a public float of less than $75 million may use a registration statement on Form S-3 for a primary offering in reliance on Instruction I.B.6 of the form (Baby Shelf Rule), which permits an issuer to sell no more than one-third of its public float within a 12-month period and requires the issuer's securities to be listed on a securities exchange. However, the SEC staff has stated in Question 116.25 of its Securities Act Forms Compliance and Disclosure Interpretations that if an issuer sells securities pursuant to a registration statement on Form S-3 under the Baby Shelf Rule and sells securities in a concurrent private placement that will be registered for resale on a separate Form S-3 in reliance on Instruction I.B.3, the resale securities would be counted toward the Baby Shelf Rule limitation at the time the resale registration statement is filed. If the total number of shares to be issued under the two registration statements exceeds the Baby Shelf Rule limitation, the issuer would need to either register the resale on Form S-1 or wait until it has sufficient capacity under the Baby Shelf Rule to register the resale on Form S-3. Thus, an issuer relying on the Baby Shelf Rule, must ensure that the total number of securities sold in the RDO and any other registered offering on Form S-3 conducted in the 12-month period does not exceed one-third of its public float.
9. **Depository Trust Corporation (DTC) and settlement.** Shares in an RDO are sold through the DTC's book-entry system as electronic book entries and not as physical stock certificates. Investors will receive a confirmation or statement containing the number of securities allocated to their account and closing and account wiring instructions. In some cases, all RDO shares are settled by delivery to the placement agent's DTC account for further delivery to investor accounts by the placement agent on an intraday basis. In other cases, the shares are allocated directly to investors' accounts with DTC or the accounts of the DTC participants or indirect participants identified by the investors for settlement. Counsel should understand the closing and settlement mechanics and ensure that all parties are made aware of the settlement instructions.
10. **Application of Regulation M and statutory underwriter role.** Under Regulation M, an RDO is a distribution and Regulation M trading restrictions apply to the transaction. As a result, the placement agent should consider the applicable restricted period and the requirement to deliver the Regulation M notice to FINRA. In addition, an RDO placement agent is acting as a distribution participant and likely would be considered a statutory underwriter from a securities law perspective as it is introducing new securities into the market. The placement agent and its counsel will want to consider this in connection with their due diligence, as well as with drafting and negotiation of the placement agency agreement.

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Anna Pinedo, Partner, Mayer Brown LLP

Anna Pinedo is a partner in Mayer Brown's New York office and co-leader of the Global Capital Markets practice. She concentrates her practice on securities and derivatives. Anna represents issuers, investment banks/financial intermediaries and investors in financing transactions, including public offerings and private placements of equity and debt securities, as well as structured notes and other hybrid and structured products.

She works closely with financial institutions to create and structure innovative financing techniques, including new securities distribution methodologies and financial products. She has particular financing experience in certain industries, including technology, telecommunications, healthcare, financial institutions, REITs and consumer and specialty finance. Anna has worked closely with foreign private issuers in their securities offerings in the United States and in the Euro markets. She also works with financial institutions in connection with international offerings of equity and debt securities, equity- and credit-linked notes, and hybrid and structured products, as well as medium term note and other continuous offering programs.

In the derivatives area, Anna counsels a number of major financial institutions acting as dealers and participants in the commodities and derivatives markets. She advises on structuring issues as well as on regulatory issues, including those arising under the Dodd-Frank Act. Her work focuses on foreign exchange, equity and credit derivatives products, and structured derivatives transactions. Anna has experience with a wide range of transactions and structures, including collars, swaps, forward and accelerated repurchases, forward sales, hybrid preferred stock and off-balance sheet structures. She also has advised derivatives dealers regarding their Internet sites and other Internet and electronic signature/delivery issues, as well as on compliance matters.

Anna regularly speaks at conferences and participates in panel discussions addressing securities law issues, as well as the securities issues arising in connection with derivatives and other financial products. She is the co-author of the leading capital markets treatise, *Corporate Finance and the Securities Laws*, published by Wolters Kluwer (6th Ed., updated 2020); co-author of *A Deep Dive Into Capital Raising Transactions*, published by the International Financial Law Review (2020); co-author of *JOBS Act Quick Start* (International Financial Law Review, 2013; updated 2014, 2016); contributor to *OTC Derivatives Regulation Under Dodd-Frank: A Guide to Registration, Reporting, Business Conduct, and Clearing* (Thomson Reuters, first ed. 2014, second ed. 2015, third ed. 2016, fourth ed. 2017, 2020-2021 ed.); co-author of *Considerations for Foreign Banks Financing in the US* (International Financial Law Review, 2012; updated 2014, 2016); co-author of *Liability Management: An Overview* (International Financial Law Review, 2011, updated 2015); co-author of *Structuring Liability Management Transactions* (International Financial Law Review, 2018); co-author of *Covered Bonds Handbook*, published by Practising Law Institute (2010, updated 2012-2014); co-author of the treatise *Exempt and Hybrid Securities Offerings*, published by Practising Law Institute (2009, second ed. 2011, updated 2014, third ed. 2017, fourth ed. 2022); and co-author of *BNA Tax and Accounting Portfolio: SEC Reporting Issues for Foreign Private Issuers* (BNA Accounting Policy and Practice Series, 2009, second ed. 2012, third ed. 2016, fourth ed. 2020). Anna is also a contributing author to Broker-Dealer Regulation (2011, second ed. 2012, updated 2020), published by Practising Law Institute. She co-authored "The Approaches to Bank Resolution," a chapter in *Bank Resolution: The European Regime* (Oxford University Press, 2016). Anna contributed to *The Future of Bank Funding and Capital: Solutions for Issuers, Opportunities for Investors* (IFR Market Intelligence, 2009). Additionally, Anna co-authored "The Ties that Bind: The Prime-Brokerage Regulation," a chapter in *Global Financial Crisis* (Globe Law and Business, 2009); "The Law: Legal and Regulatory Framework," a chapter in *PIPEs: A Guide to Private Investments in Public Equity* (Bloomberg, 2006); and "The Impact Security: Reimagining the Nonprofit Capital Market," a chapter in *What Matters: Investing in Results to Build Strong, Vibrant Communities* (Federal Reserve Bank of San Francisco and Nonprofit Finance Fund, 2017). Anna is a contributor to Practising Law Institute's "BD/IA: Regulation in Focus" blog.

Anna is a member of the American Bar Association's (ABA) Committee on the Federal Regulation of Securities, a member of the subcommittee on Disclosure and Continuous Reporting, chair of the subcommittee on Securities Registration, chair of the subcommittee on Annual Review, and a member of the task force on the future of securities regulation.

She has participated in the drafting committee for the ABA's comment letters on such topics as securities offering reform, revisions to the definition of accelerated filer and smaller reporting company, amendments to the accredited investor definition; amendments to the exempt offering framework; and various JOBS Act-related and disclosure effectiveness related matters. Anna also is a member of the ABA Committee on the Regulation of Futures and Derivatives Instruments. Anna is a chair of the Structured Products Association Legal, Regulatory and Compliance Executive Committee. She is a member of the Mortgage Bankers Association's Mortgage REIT Council and a member of the MBA's Secondary & Capital Markets Committee.

Anna is an adjunct professor at the George Washington University School of Law and member of the George Washington University Center for Law, Economics & Finance Advisory Board. She is a member of the Visiting Committee of the Law School of the University of Chicago. Anna was a member of the University of Chicago Legal Forum during her time at the University of Chicago Law School.

Ziv Schwartz, Associate, Mayer Brown LLP

Ziv Schwartz is an associate in the New York office of Mayer Brown and a member of the Corporate & Securities practice.

Ziv received his doctoral degree from the University of Chicago Law School. He also holds an LL.M. degree from the University of Chicago Law School and an LL.B., *magna cum laude*, from the Hebrew University in Jerusalem.

Prior to joining Mayer Brown, Ziv served as a law clerk to the Honorable Constandinos Himonas of the Utah Supreme Court and to the Honorable Salim Joubran of the Supreme Court of Israel. Ziv was also an associate at a prominent Israeli law firm.