

# Capital Markets & Securities

June 21, 2017

## What You Need To Know:

- NASDAQ has issued a request for comments regarding a proposed revision to the “20% voting rule” that currently requires listed companies to obtain shareholder approval when issuing 20% or more of their stock in a non-public offering (a “Qualified Financing”) below the greater of the stock’s market or book value.
- The proposed revision (i) eliminates the need to obtain shareholder approval for issuances at a price less than book value; (ii) changes the definition of market value from a 1-day closing bid price metric to a five day trailing average closing price metric; and (iii) adds an additional requirement that each Qualified Financing must be either approved by a majority of the listed company’s independent directors, or its shareholders.
- Comments should be submitted by email to [comments@nasdaq.com](mailto:comments@nasdaq.com) by July 31, 2017.

## Nasdaq Solicits Comments On Shareholder Approval Rules For Private Placements

 By **Park S. Bramhall, Esq.**

On June 14, 2017, Nasdaq posted a notice that it was seeking comments (the “**Comment Solicitation**”) <sup>1</sup> to a potential revision to Nasdaq Listing Rule 5635(d) <sup>2</sup> (the “**Private Placement Rules**” and such proposed revision, the “**Proposed Rule**”), <sup>3</sup> which currently requires listed companies to obtain shareholder approval when issuing common stock or securities convertible into common stock equal to 20% or more of the shares outstanding in a nonpublic offering (a “**Qualified Financing**”) <sup>4</sup> at a price less than the greater of the book value <sup>5</sup> or market value. <sup>6</sup> In brief, the Proposed Rule would revise the Private Placement Rules to (i) eliminate the need to obtain shareholder approval for issuances of common stock at a price less than book value; (ii) change the definition of market value for purposes of the Private Placement Rules from the closing bid price to a five-day trailing average of the closing price as reflected on [www.Nasdaq.com](http://www.Nasdaq.com); and (iii) add a requirement that the proposed transaction be approved by either a majority of the issuer’s independent directors, <sup>7</sup> or its shareholders.

The table below summarizes the applicable requirements under both the current version of the Private Placement Rules and those same rules as amended by the Proposed Rule.

Current Version of Rule 5635(d)	Proposed Version of Rule 5635(d)
<p><b>Shareholder Vote Required if:</b></p> <ol style="list-style-type: none"> <li>1. Issuance is <math>\geq</math> 20% of an issuer’s outstanding common stock; and</li> <li>2. Issuance occurs at a price less than the greater of:               <ol style="list-style-type: none"> <li>a. book value; or</li> <li>b. market value</li> </ol> </li> </ol>	<p><b>Shareholder Vote Required if:</b></p> <ol style="list-style-type: none"> <li>1. Issuance is <math>\geq</math> 20% of an issuer’s outstanding common stock; and</li> <li>2. Either of the following occurs:               <ol style="list-style-type: none"> <li>a. issuance occurs at a price less than the issuer’s average closing price for the five preceding trading days as reflected on <a href="http://www.Nasdaq.com">www.Nasdaq.com</a>; or</li> <li>b. the issuance is not approved by the issuer’s independent directors</li> </ol> </li> </ol>

## I. BACKGROUND

The Comment Solicitation is a follow-up to the comment solicitation that Nasdaq, working with the Nasdaq Listing and Hearing Review Council (the “**Listing Council**”),<sup>8</sup> launched on November 16, 2015 (the “**Prior Comment Solicitation**”).<sup>9</sup> In contrast to the current Comment Solicitation, the Prior Comment Solicitation requested comments on potential updates to all of Nasdaq’s shareholder approval rules,<sup>10</sup> and a total of 17 comment letters were received from Nasdaq-listed companies, investors and other market participants that expressed a wide range of views.<sup>11</sup> While neither Nasdaq nor the Listing Council made any determination that change was necessary or appropriate,<sup>12</sup> one theme that emerged from the comments is the need to focus on potential revisions to the Private Placement Rules.<sup>13</sup>

## II. OVERVIEW OF THE PROPOSED CHANGES

### A. Elimination of the Book Value Requirement

The book value requirement was eliminated on the grounds that the metric (i) was generally not considered when pricing or seeking shareholder approval of financings; (ii) was not perceived as providing any substantive protection to shareholders; (iii) was not an appropriate measure of the market value of an issuer’s stock; and (iv) could have a disproportionate impact on certain issuers under certain circumstances.<sup>14</sup> In particular, with respect to the first point, the comments received in response to the Prior Comment Solicitation indicated that book value is rarely, if ever, considered by either issuers or investors when pricing capital-raising transactions, or by shareholders when they are asked to vote to approve a proposed transaction.<sup>15</sup> The remaining three points are interrelated in the sense that book value may not be an appropriate measure of the current value of an issuer’s stock since it is primarily an accounting measure based on the historic cost of an issuer’s assets, and as such may not provide the protection to existing shareholders that was contemplated when the Private Placement Rules were originally adopted in 1990.<sup>16</sup> One of the consequences arising from this is that the existing book value test can also have a disproportionate impact on companies in certain industries and at certain times. For example, during the financial crisis in 2008 and 2009, many banks and finance related companies traded below book value.<sup>17</sup> Similarly, companies that make large investments in infrastructure may trade below the accounting carrying value of those assets.<sup>18</sup> Under the existing book value test, an issuer conducting a Qualified Financing in this situation at a discount to book value would be required to obtain shareholder approval even if the offering priced at a premium to the current market price on the theory that the offering would be dilutive to existing shareholders.<sup>19</sup> The reality of the matter, however, is that the reason the issuer’s stock is trading below book value in these circumstances is that the market believes that the assets are overvalued.<sup>20</sup> Viewed in this light, the existing book value test provides little protection to existing shareholders and, potentially, could prove counterproductive by impeding potential non-dilutive financings.

### B. Adoption of a Trailing Five-Day Average Price and the Independent Director Approval Requirements

Under the Private Placement Rules, “market value” is defined as an issuer’s **closing bid** price. A number of the comments received in response to the Prior Comment Solicitation expressed the view that (i) the bid price was not always transparent to either the issuer or investors and did not always reflect an actual price at which a security has traded; and (ii) investors and issuers often rely on an average price over a prescribed period of time for pricing issuances because it can smooth out unusual fluctuations in price.<sup>21</sup> In this context, the Proposed Rule replaces the single day’s **closing bid** metric with a trailing five-day **closing price** metric on the grounds that it will enhance transparency and investor protections.<sup>22</sup> In particular, a closing price metric is (A) generally more transparent to investors and issuers because it is reported on financial websites;<sup>23</sup> and (B) a more stringent requirement than the current closing bid price requirement because it will represent an actual sale that typically occurs at the same or greater price than the bid price because sales generally take place between the bid and ask prices.<sup>24</sup> In addition to representing a more stringent requirement than the current bid, the securities closing price listed on [www.Nasdaq.com](http://www.Nasdaq.com) for an issuer is also likely to provide a more accurate proxy for the market value of its securities because it is typically derived from the closing auction on Nasdaq and thereby reflects actual sale prices at one of the most liquid times of the day.<sup>25</sup>

While the benefits of transitioning from a closing bid to a closing price metric are fairly clear, the case for transitioning to a trailing five-day average price metric is less compelling. On one hand, the change would accommodate the market practices of many market participants since it would supersede existing Nasdaq guidance prohibiting the use of average prices.<sup>26</sup> On the other hand, there are potential negative consequences to using a five-day average as the measure of whether shareholder approval is required. For example, in a declining market, the five-day average price will always be above current market price, thus making it difficult for issuers to close transactions because the investors could potentially buy the same shares in the market at a discount to the five-day average price,<sup>27</sup> while conversely, in a rising market, the five-day average price would allow potentially dilutive transactions to occur without shareholder approval because the average will always be, by definition, below the issuer’s current market price.<sup>28</sup> In addition, as noted in the Comment Solicitation, if material news is announced during the five-day period, the average could be a worse reflection of the market value than the closing price after the news is disclosed.

Notwithstanding these potential issues, Nasdaq and the Listing Council proposed the change to a trailing five-day average price metric on the grounds that these risks are already accepted in the market as evidenced by the frequent use of an average price in transactions,<sup>29</sup> and that there are state law obligations<sup>30</sup> and federal anti-fraud provisions that also protect against some of these concerns.<sup>31</sup>

That said, to provide an additional safeguard against the misuse of the average price provisions, the Proposed Rule provides that a shareholder vote will be required in connection with a Qualified Financing irrespective of the proposed issuance price unless it is approved by either a committee of independent directors or a majority of the independent directors on the board.<sup>32</sup>

### **C. Consolidation of Nasdaq Listing Rules 5635(d)(1) and 5635(d)(2)**

From a substantive standpoint, there is significant overlap between Nasdaq Listing Rules 5635(d)(1) and 5635(d)(2). As such, the Proposed Rules combine these two paragraphs but do not intend for this change to affect the substance of these rules.<sup>33</sup>

### **III. NEXT STEPS**

The comment period for the Proposed Rules will run until July 31, 2017, and comments should be submitted by email to [comments@nasdaq.com](mailto:comments@nasdaq.com).

## **Appendix A**

### **EXISTING RULE 5635(D)**

#### **(d) Private Placements**

Shareholder approval is required prior to the issuance of securities in connection with a transaction other than a public offering involving:

(1) the sale, issuance or potential issuance by the Company of common stock (or securities convertible into or exercisable for common stock) at a price less than the greater of book or market value which together with sales by officers, directors or Substantial Shareholders of the Company equals 20% or more of common stock or 20% or more of the voting power outstanding before the issuance; or

(2) the sale, issuance or potential issuance by the Company of common stock (or securities convertible into or exercisable 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.

### **DRAFT OF PROPOSED REVISED RULE 5635(D)**

#### **(d) Private Placements**

Shareholder approval is required prior to the issuance of securities in connection with a transaction, other than a public offering, involving the sale, issuance or potential issuance by the Company of common stock (or securities convertible into or exercisable for common stock), which:

(1) alone or together with sales by officers, directors or Substantial Shareholders of the Company equals 20% or more of common stock or 20% or more of the voting power outstanding before the issuance; and

(2)(A) is at a price less than 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 for the issuance; or

(B) is not approved either by: (i) Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate, or (ii) a committee comprised solely of Independent Directors.

**REDLINE SHOWING PROPOSED REVISIONS TO RULE 5635(D)**  
**(Additions in red text and deletions in blue strike-out text)**

**(d) Private Placements**

Shareholder approval is required prior to the issuance of securities in connection with a transaction other than a public offering involving:

~~(1) the sale, issuance or potential issuance by the Company of common stock (or securities convertible into or exercisable for common stock)~~, **at a price less than the greater of book or market value** which:

**(1) alone or** together with sales by officers, directors or Substantial Shareholders of the Company equals 20% or more common stock or 20% or more of the voting power outstanding before the issuance; **or and**

**(2) (A) is at a price less than 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 for the issuance; or**

**(B) is not approved either by Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate or by a committee comprised solely of Independent Directors.**

~~(2) the sale, issuance or potential issuance by the Company of common stock (or securities convertible into or exercisable 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.~~

<sup>1</sup> The Notice and Comment Solicitation can be accessed [here](#) and [here](#), respectively.

<sup>2</sup> The text of the Private Placement Rules and the Proposed Rule as well as a redline showing the Private Placement Rules as amended by the Proposed Rule are set forth in [Appendix A](#).

<sup>3</sup> Rule 5635(d) can be accessed [here](#).

<sup>4</sup> IM-5635-3 (Definition of a Public Offering) outlines the factors the Nasdaq staff considers when determining whether an issuance of shares is a public offering and describes how those factors are applied. The text of IM-5635-3 can be accessed [here](#).

<sup>5</sup> For purposes of Nasdaq's shareholder approval rules, "**book value**" is defined as "the stockholders' equity from the company's most recent public filing with the SEC. Book value per share is the stockholders' equity divided by the total shares outstanding. Goodwill and other intangible assets are included in a company's book value. See *Nasdaq FAQ Identification Number 273*, accessible [here](#).

<sup>6</sup> For purposes of Nasdaq's shareholder approval rules, "**market value**" is defined as "*the consolidated closing bid price per share immediately preceding the entering into of the binding agreement to issue the securities,*" which will be either (i) the previous trading day's consolidated closing bid price if the transaction is entered into during market hours and before the close of the regular session at 4 PM Eastern Time; or (ii) the consolidated closing bid price on the date the securities purchase agreement is executed if the transaction is entered into after the close of the regular session. See *Nasdaq FAQ Identification Number 271 ("FAQ 271")*, accessible [here](#).

<sup>7</sup> Nasdaq Listing Rule 5605(a)(2) and IM-5605 (Definition of Independence) set forth the criteria for determining director independence and can be accessed [here](#) and [here](#), respectively.

<sup>8</sup> The Listing Council is a standing independent advisory committee appointed by the Board of Directors of The Nasdaq Stock Market (the "**Board**"), whose mission is to review the application of Nasdaq's listing rules and public policy issues related to listing, and, where appropriate, suggest new or modified rules for consideration by the Board. The Listing Council is comprised of individuals with diverse credentials and each Listing Council member is a respected leader in his or her field, committed to working with Nasdaq to enhance investor protection and the integrity of the Nasdaq Stock Market. The roster of the current members of the Listing Council is available [here](#).

<sup>9</sup> The notice for the Prior Comment Solicitation and its text can be accessed [here](#) and [here](#), respectively.

<sup>10</sup> Nasdaq Listing Rules 5365(a)-(c) set forth the circumstances pursuant to which a shareholder vote will be required in connection with (i) the acquisition of the stock or assets of another company; (ii) grants of equity-based compensation to officers, directors, employees or consultants; and (iii) a change of control, respectively, and can be accessed [here](#).

<sup>11</sup> See *Comment Solicitation* at Page 1.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*, at Page 2.

<sup>14</sup> *Id.*, at Pages 3-4.

<sup>15</sup> *Id.*, at Page 3.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*, at Pages 3-4.

<sup>18</sup> *Id.* at Page 4.

<sup>19</sup> *Id.*

<sup>20</sup> Of course, it is possible that the market is mistakenly undervaluing an issuer's assets. That said, to the extent that this is the case, the error presumably would not be due to a lack of information regarding those assets since both the Nasdaq Listing Rules and corresponding Securities and Exchange Commission disclosure requirements are designed to ensure that investors and the market receive adequate information to accurately value listed companies.

<sup>21</sup> See *Comment Solicitation* at Page 2. In this regard, it should be noted that per FAQ 271, the use of an average price is not permitted for purposes of calculating an issuer's "market value." In particular, FAQ 271 states in pertinent part "*... an average price over any period of time is not acceptable [as a measure of market value].*"

<sup>22</sup> *Id.*

<sup>23</sup> To obtain the closing bid price, issuers are instructed to call their representative at Nasdaq's Market Intelligence Desk, while other market participants are instructed to call Nasdaq's Market Intelligence Desk or Nasdaq MarketWatch to request the consolidated closing bid price. See *Nasdaq FAQ Identification Number 272*, accessible [here](#).

<sup>24</sup> See *Comment Solicitation* at Page 2.

<sup>25</sup> *Id.* The Nasdaq closing auction is designed to gather the maximum liquidity available for execution at the close of trading and to maximize the number of shares executed at a single price at the close of the trading day. The closing auction promotes accurate closing prices by offering specialized orders available only during the closing auction and integrating those orders with regular orders submitted during the trading day that are still available at the close. *Id.* at Pages 2-3.

<sup>26</sup> See, e.g., FAQ 271.

<sup>27</sup> See *Comment Solicitation* at Page 3. That said, while as a technical matter this is obviously true, as a practical matter, it is unlikely that an investor or group of investors would be able to purchase a significant block of an issuer's stock without moving the stock price above the five-day trailing average. More to the point, since the transaction in question involves the potential purchase of at least 20% of an issuer's outstanding stock, it is difficult to imagine that an investor or group of investors would be able to purchase the shares in the open market without moving the stock price significantly above the five-day trailing average.

<sup>28</sup> *Id.*

<sup>29</sup> We note that the issue of whether the issuer and investors participating in a Qualified Financing are willing to assume this type of risk does not seem particularly relevant in the context of a Listing Rule that is intended to protect, ostensibly, an issuer's existing shareholders from dilution.

<sup>30</sup> This is presumably a reference to the fiduciary duties that apply to directors and managers under state law. We note, however, that under certain circumstances, such fiduciary duties can be waived in an issuer's governance documents. See, e.g., §18-1101(c) of the Delaware Limited Liability Company Act, which expressly permits parties to a limited liability company agreement to waive all duties (including fiduciary duties) other than the implied covenant of good faith and fair dealing. §18-1101(c) of the Delaware Limited Liability Company Act can be accessed [here](#).

<sup>31</sup> See *Comment Solicitation* at Page 3.

<sup>32</sup> As a preliminary matter, we note that the independence standards set forth in Nasdaq Listing Rule 5605(a)(2) and IM-5605 (Definition of Independence) are primarily intended to measure whether a particular director can be considered to be independent of the issuer on whose board he or she serves, which is fine as far as that goes. In our view, however, if the intent is to provide an additional protection for the shareholders, the more relevant issue is whether the directors required to approve a Qualified Financing are disinterested in the transaction itself, i.e., that they are unconflicted. The standard imposed by the Proposed Rule, however, would not prohibit a conflicted director from approving a Qualified Financing. That said, we note that the directors and managers of an issuer are typically subject to fiduciary duties under state law but, as also noted above in footnote 31, these fiduciary duties can be waived under certain circumstances.

<sup>33</sup> See *Comment Solicitation* at Page 4.

## Contacts

Please contact any of the attorneys listed, or any other member of Lowenstein Sandler's Capital Markets & Securities Group, for further information on the matters discussed herein.

### **Park S. Bramhall, Esq.**

Counsel

T 646.414.6925 | [pbramhall@lowenstein.com](mailto:pbramhall@lowenstein.com)

### **Steven M. Skolnick Esq.**

Partner and Chair, Capital Markets & Securities Practice

T 973.597.2476 | [sskolnick@lowenstein.com](mailto:sskolnick@lowenstein.com)

### **Peter H. Ehrenberg, Esq.**

Partner

T 212.204.8697 | [pehrenberg@lowenstein.com](mailto:pehrenberg@lowenstein.com)

### **John D. Hogoboom, Esq.**

Partner

T 646 414 6849 | [jhogoboom@lowenstein.com](mailto:jhogoboom@lowenstein.com)

### **Laura R. Kuntz, Esq.**

Partner

T 973.597.2398 | [lkuntz@lowenstein.com](mailto:lkuntz@lowenstein.com)

### **Michael J. Reinhardt, Esq.**

Partner

T 646.414.6857 | [mreinhardt@lowenstein.com](mailto:mreinhardt@lowenstein.com)

### **Alan Wovsaniker, Esq.**

Partner

T 973.597.2564 | [awovsaniker@lowenstein.com](mailto:awovsaniker@lowenstein.com)

---

NEW YORK

PALO ALTO

NEW JERSEY

UTAH

WASHINGTON, D.C.

This Alert has been prepared by Lowenstein Sandler LLP to provide information on recent legal developments of interest to our readers. It is not intended to provide legal advice for a specific situation or to create an attorney-client relationship. Lowenstein Sandler assumes no responsibility to update the Alert based upon events subsequent to the date of its publication, such as new legislation, regulations and judicial decisions. You should consult with counsel to determine applicable legal requirements in a specific fact situation.