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Client Alert

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SEC Approves Changes to Nasdaq Shareholder Approval Rules

By Jennifer Dressler

What You Need To Know:

- **Average closing price for five days preceding 20% issuance can be used to determine market value.**
- **Book value is no longer relevant for determining need for shareholder approval.**

The Securities Exchange Commission (the SEC) has approved changes to Nasdaq Rule 5635(d) (the Rule) relating to the shareholder approval requirements for below-market issuances of 20% or more of common stock or voting power outstanding, as explained in more detail below.

Effective September 26, 2018, The Nasdaq Stock Market LLC (Nasdaq) modified the Rule to:

i. Change the definition of market value for purposes of the shareholder approval rule under the Rule
ii. Eliminate the requirement for shareholder approval of issuances at a price less than book value but greater than market value
iii. Make other conforming changes

The modified Rule changes the circumstances in which shareholder approval is required for issuances of securities in connection with transactions that do not meet the Nasdaq test of a public offering. Previously, the Rule required shareholder approval prior to 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 that, together with sales by officers, directors, or Substantial Shareholders [holders of 5% or more of the common stock or 5% or more of the voting power outstanding] 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 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. "Market value," as applied to the Rule, was defined as the closing bid price.

The modified Rule combines two clauses above into one definitional section, resulting in a more readable Rule that now requires shareholder approval "prior to a 20% Issuance at a price that is less than the Minimum Price."

Minimum Price

For purposes of the Rule, the definition of market price was amended to the "Minimum Price," which is 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. Pursuant to the change, shareholder approval would be required prior to a 20% issuance that is less than the Minimum Price, but would not be required in an issuance of 20% or more at a price that is less than book value but greater than market value.

Nasdaq reasoned that using the closing bid, rather than the bid price (i) reflects actual sale prices at one of the most liquid times of the day; (ii) is highly transparent to investors; (iii) is less prone to manipulation than the bid price; and (iv) is consistent with the approach of other exchanges.

Nasdaq acknowledged that using a five-day average as the sole measure of whether shareholder approval is required can have negative consequences. In a declining market, the five-day average closing price will be above the current market price, which could make it difficult for companies to close transactions. To offset this concern, the revised Rule defines market value as the lower of the closing price or the five-day average closing price, so deals can still get done.

Using the five-day average in a rising market also raises additional issues, as the issuance will appear to be at a discount. Nevertheless, Nasdaq believes these risks are already accepted by the market in order to have some certainty when pricing a deal.

Nasdaq believes this minimum price formulation will provide companies with additional flexibility to complete transactions without shareholder approval as long as the transaction occurs at a price greater than the lower of the two measures.

The modified Rule also eliminates the requirement for shareholder approval of private placement issuances at a price below book value. Nasdaq now takes the position that book value is an accounting measure based on the historic costs of assets rather than current value. As such, Nasdaq believes book value is not an appropriate measure of whether a transaction is dilutive or whether it should otherwise require shareholder approval.

SEC Analysis and Findings

The SEC agreed with commentators who supported the use of a five-day average closing price, characterizing it as relating to the way transactions are actually structured to help smooth out price fluctuations. The SEC believes that the flexibility afforded to companies to close transactions under the modified Rule will not undercut the investor protection requirements of the Securities Exchange Act of 1934, since other Nasdaq rules continue to limit companies' ability to issue securities in private placements without shareholder approval. Such rules include the requirement for shareholder approval for (i) discounted issuance of stock to a company's officers, directors, employees, or consultants under Nasdaq's equity compensation rules; (ii) any issuance that resulted in a change of control; and (iii) the acquisition of stock or assets of another company, including where an issuance increases voting power or common shares by 5% or more and an officer or director or Substantial Shareholder has a 5% direct or indirect interest (or collectively 10%) in the company or assets to be acquired.

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

ALAN WOVSANIKER
Partner
T: 973.597.2564
awovsaniker@lowenstein.com

JENNIFER DRESSLER
Associate
T: 973.422.6480
jdressler@lowenstein.com