Corporate Finance Alert

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When Accessing the Equity Markets Requires an Unexpected Shareholder Vote

In certain situations, NYSE and NASDAQ rules require a shareholder vote before a company can issue equity or convertible securities. The shareholder approval process — calling a shareholder meeting, preparing a proxy statement, clearing the proxy with the SEC — adds both time and expense that may not be compatible with the capital or strategic needs of the issuer. Understanding these rules is particularly important if a company seeks speedy access to the equity markets to fund a strategic acquisition or execute an opportunistic change in its capital structure.

The shareholder approval requirement may be triggered by securities issuances involving:

- **20 percent or more of the common stock or voting power** of an issuer (especially since the exchanges may aggregate several separate issuances into a single transaction for the purpose of calculating the 20 percent threshold);
- **Related parties** (such as directors, officers, affiliates or significant shareholders);
- **A change of control** (often in the context of funding an acquisition); or
- **Convertible securities, options or warrants** (in which case determining whether shareholder approval is required is especially complicated).

The following discussion outlines the rules that any NYSE- or NASDAQ-listed issuer should consider in structuring an equity offering if it hopes to avoid triggering a shareholder vote. The charts at the end of this discussion outline the questions an issuer should ask when contemplating an equity or convertible offering.[1]

Dilutive Transactions and the 20 Percent Rule

Issuers listed on the NYSE or NASDAQ must obtain shareholder approval before issuing common stock, or securities convertible into or exercisable for common stock, representing 20 percent or more of the common stock or voting power outstanding prior to the issuance, subject to certain exceptions.[2]

NYSE: The NYSE provides two limited exceptions to the 20 percent rule if a transaction utilizes cash consideration.[3]

The first, and most commonly used, exception is any public offering for cash. The NYSE does not define "public offering," but it has indicated that the mere fact that an equity offering is registered under the Securities Act of 1933 will not suffice; the issuance generally must involve a firm commitment underwriting and an actual marketing process

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that reaches beyond a limited set of buyers. Most underwritten transactions for NYSE-listed issuers would qualify for this exception, and the sale price in public offerings for cash can be lower than the current book or market value of the issuer's common stock. This exemption also applies to other offerings for cash, including bought deals and rights offerings.

The second exception under the NYSE rules is a "*bona fide* private financing for cash," where the financing involves a sale of common stock (or convertible securities) at a price (or conversion price) at least as great as each of the (i) book value and (ii) market price of the issuer's common stock. To the NYSE, a private financing is "*bona fide*" if it involves a sale to either (i) a registered broker-dealer with a view to resale or (ii) multiple purchasers under circumstances in which no group of related purchasers has (or could acquire by exercise or conversion) more than 5 percent of the issuer's outstanding pre-issuance common stock or voting power.[4]

NASDAQ: Although similar in many regards to its NYSE counterpart, the NASDAQ 20 percent rule counts not only the shares to be issued by the company, but also aggregates any sales in the same series of transactions by officers, directors and substantial shareholders of the issuer in calculating the 20 percent threshold.[5] Like the NYSE, **NASDAQ excludes public offerings** that meet its criteria from its shareholder approval requirement, and most firm commitment underwritten transactions qualify for this public offering exception.[6] The NASDAQ rules do not define "public offering" and provide that the determination as to whether a transaction is a "public offering" will be a facts-and-circumstances inquiry that considers the type of offering, the manner in which it is marketed, how widely the securities are distributed and the extent to which the issuer controls the offering. Unlike the NYSE exception, the securities offered need not be sold for cash.

NASDAQ also excludes certain private financings (defined as "other than a public offering") where the financing involves a sale of common stock (or convertible securities) at a price (or conversion price) at least as great as each of the (i) book value and (ii) market price of the issuer's common stock. Again in contrast to the NYSE version, NASDAQ's private financing exception does not require cash consideration. However, neither of NASDAQ's exceptions applies when the securities are issued in connection with the acquisition of stock or assets of another company. In that case, NASDAQ does impose a cash consideration requirement, and the transaction also must be a public offering.

Treatment of Convertible Securities Under the 20 Percent Rule

In calculating the 20 percent threshold under the rules of either exchange, the issuance of options, warrants and convertible securities must be carefully considered.

Convertible Notes: Historically, a holder of convertible notes had the right to convert such notes into a fixed number of shares, subject to limited and well-established anti-dilution provisions. When convertible securities are sold for cash and are convertible into shares of the issuer at a "conversion price"[7] that is greater than each of the market price and book value of the stock at the time of issuance of the convertible security, the issuance qualifies for the private financing exceptions available under both the NYSE and NASDAQ rules.

However, over the last several years, variations on the traditional convertible note have developed. More recently, for a host of accounting, tax and capital market considerations, a significant portion of all convertible notes issued have provided that upon conversion the issuer may (or is required to) settle the convertible note by delivering to holders cash or a combination of cash and shares. One common variation of the latter requires the delivery of the principal amount of the convertible notes in cash, and any excess value above the principal amount in shares (commonly referred to as net share settlement). Under the rules and interpretations of both exchanges, including this feature would make the exceptions to the shareholder approval rules described above unavailable. **While various structural techniques have developed over the years to address this constraint, the**

20 percent limitation remains a significant barrier that must be addressed at the outset when structuring convertible notes.

In determining compliance with the exchange rules, care must be taken to ensure that the correct number of shares is taken into account. For example, both exchanges have expressed the view that anti-dilution provisions, including commonly used provisions, should be considered in making this determination. In addition, in most cases, adjustments to the conversion rate that provide holders with additional shares upon the occurrence of specific corporate transactions also should be included to determine compliance with the 20 percent limitation. These, and similar positions taken by the exchanges, pose significant sizing constraints on the issuance of convertible notes. Further challenges to compliance arise when convertible notes involve structural enhancements, such as "call spread" transactions, which, from the issuer's perspective, have the effect of synthetically increasing the conversion price of the notes. A detailed analysis of these structures is beyond the scope of this discussion, and counsel should be consulted early in the process.

Warrants: The exchanges differ in their approach to valuing warrants for common stock when determining the 20 percent threshold. The NYSE advises that warrants for common stock be valued using the Black-Scholes model while NASDAQ attributes a value of $0.125 for each full warrant. NASDAQ will exclude from the calculation the shares underlying warrants if:

- the amount of common stock to be issued at a discount does not equal or exceed the 20 percent threshold; and
- the warrants are not exercisable for six months following the transaction and are exercisable for not less than the greater of book or market value.

Both exchanges permit "share cap" features in warrant issuances in which, for example, the number of shares issuable upon conversion is capped at less than 20 percent of the outstanding preissuance common stock until the requisite shareholder vote is obtained. However, NASDAQ will not permit share cap issuances to also include "sweetener" or "penalty" provisions, such as changes to the coupon rate, that apply if shareholder approval is (or is not) obtained. The NYSE, on the other hand, permits such features so long as they are not coercive to the shareholders' vote. The NYSE has allowed an increase in the cash dividend or interest rate if shareholder approval is not obtained by contractual deadlines, but not a penalty provision that would increase the number of shares into which the warrant would be convertible unless the total potential dilution, including the "penalty" shares, is less than 20 percent.

Related-Party Transactions

Shareholder approval also is required for securities issuances to certain related parties.

NYSE: The NYSE considers directors, officers and "substantial security holders" (those controlling 5 percent or more of the issuer's issued and outstanding shares or voting power) to be "Related Parties."[8] **The NYSE requires shareholder approval if the securities to be issued to a single Related Party could exceed 1 percent of the outstanding preissuance common stock or voting power**. The NYSE also will include subsidiaries, affiliates and family members of Related Parties in the calculation. However, if the Related Party issuance is only to a Substantial Security Holder (and not another type of Related Party), the threshold rises to 5 percent of the issuer's outstanding preissuance common stock or voting power, provided that the issuance is for cash at a price at least equal to each of the book and market value of the issuer's common stock.

NASDAQ: **By contrast, the NASDAQ shareholder approval requirement for issuances to Related Parties is implicated only in the acquisition context**. (The NASDAQ definition of Related Parties

is similar to the NYSE's definition.)[9] Shareholder approval is required for issuances of equity as consideration for the acquisition of stock or assets of another company if:

- any Related Party has a 5 percent or greater interest (or multiple Related Parties collectively have a 10 percent or greater interest)[10] in
  - the company or asset to be acquired, or
  - the class of equity to be paid in the transaction; and
- the present or potential issuance could result in a 5 percent or greater increase in the outstanding preissuance common stock or voting power.[11]

For example, to finance an acquisition, an acquiror with 100 million shares outstanding plans to issue debt securities potentially convertible into 8 million shares of common stock. If an investment fund that is a substantial shareholder of the acquiror is also an investor in the target and currently controls 6 percent of the target, the equity offering by the acquiror will require a vote of the acquiror's shareholders.

Change-of-Control Transactions

Both exchanges require shareholder approval for securities issuances (or potential issuances) that could result in a change of control of the issuer, but neither exchange precisely defines what constitutes a change of control.

NYSE: The NYSE rules do not define a change of control, but past practice suggests the exchange will look beyond a defined percentage test to a facts-and-circumstances determination of whether a change of control has occurred.[12] Furthermore, the exchange has indicated that even smaller placements (*e.g.*, less than 20 percent of the issuer's outstanding shares) may be deemed a change of control if the placement is to a single purchaser and carries certain governance rights, such as the right to appoint directors to the board and to dismiss or veto the appointment of the issuer's CEO. In addition, if the purchaser is given blocking rights with respect to matters usually determined by a shareholder vote or is granted director representation rights that are disproportionate to its investment, this may violate the NYSE voting rights rule.[13] A provision that is inconsistent with the NYSE voting rights rule cannot be cleansed by a shareholder vote, so it is important to preclear any blocking rights under consideration with the NYSE before an agreement is signed.

NASDAQ: Similarly, the NASDAQ rules do not define a change of control, but staff interpretations provide guidance.[14] The interpretations state that a change of control would generally be deemed to occur if, for example:

- an investor or a group[15] would own, or have the right to acquire, 20 percent or more of the shares of the issuer's outstanding common stock or voting power; and
- such ownership or voting power would be the largest ownership position in the company.[16]

However, the NASDAQ interpretations note that whether a transaction constitutes a change of control is a facts-and-circumstances test, and a change of control may be deemed to occur at a lower ownership threshold — for example, where there are other relationships or agreements between the issuer and the investor group.[17]

Distressed Company Exception

Both the NYSE and NASDAQ provide an additional exception from the shareholder approval requirements in situations where the delay imposed by obtaining prior shareholder approval

would "seriously jeopardize the financial viability" of the issuer.[18] However, this exception typically is used (and the exchanges are only likely to approve its use) only under extreme circumstances, such as when the alternative for the issuer would be bankruptcy or liquidation. For example, this was the exception that Bear Stearns invoked to permit its sale to JPMorgan Chase in March 2008 without shareholder approval.[19] In order for both NYSE- and NASDAQ-listed companies to utilize this exception, the issuer's audit committee must expressly state that it is relying on the exception, and the issuer's exchange must grant the exception. Furthermore, at least 10 days before the issuance, the issuer must notify its shareholders that it plans to rely on the exception rather than seek their approval and make a public announcement either by filing a current report on Form 8-K or by issuing a press release.

Counting the Votes

If a shareholder vote is required, approval under both NYSE and NASDAQ rules requires a majority of total votes cast on a proposal, and the NYSE imposes an additional quorum condition requiring that a majority in interest of all securities entitled to vote actually vote.[20] On both exchanges, shares held by related parties and, in the acquisition context, shares held by a potential target or merger partner, are entitled to participate in the vote. However, this is not the case for NYSE-listed companies with respect to common stock acquired in a transaction related to the transaction giving rise to the need for the shareholder vote. Those shares may be voted for purposes of meeting the NYSE quorum requirements, but such votes may not be counted to determine whether a proposal has been approved. Under the NASDAQ rule, a purchaser who has acquired shares but will acquire additional shares upon a shareholder vote may not vote the initially acquired shares in such a shareholder vote. In calculating majority approval, both exchanges permit an issuer to count in the denominator only shares actually issued and outstanding, and not treasury shares (*e.g.*, previously repurchased shares that have not been retired), shares held by a subsidiary or shares reserved for issuance (*e.g.*, set aside to settle future conversions of a security).[21]

Series of Transactions

Where two or more issuances of securities occur close in time to one another, the exchanges may aggregate the issuances into a single transaction for the purpose of calculating the percentage thresholds under their respective rules. As a result, the issuer may reach the applicable 1-percent, 5-percent, 20-percent or change-in-control threshold even if no single transaction would otherwise trigger the shareholder vote. Factors that are considered in determining aggregation of transactions include:

- the timing of the issuances;
- common investors;
- contingencies between the transactions;
- common use of proceeds; and
- whether the transactions are part of a common plan of financing.

Special Situations

Issuers should keep the following special situations in mind when considering a contemplated issuance.

NYSE and NASDAQ listing rules prohibit an issuer from taking any action, including issuing securities, that would disparately reduce or restrict the voting rights of existing shareholders.[22] The rules specifically forbid the issuance of a new class of super voting stock (stock that carries more than one vote per share) or the issuance through an exchange offer of stock with voting rights that are less than the per-share voting rights of the existing common stock. Shareholder approval cannot cure an issuance that violates the exchanges' respective voting rights rules.

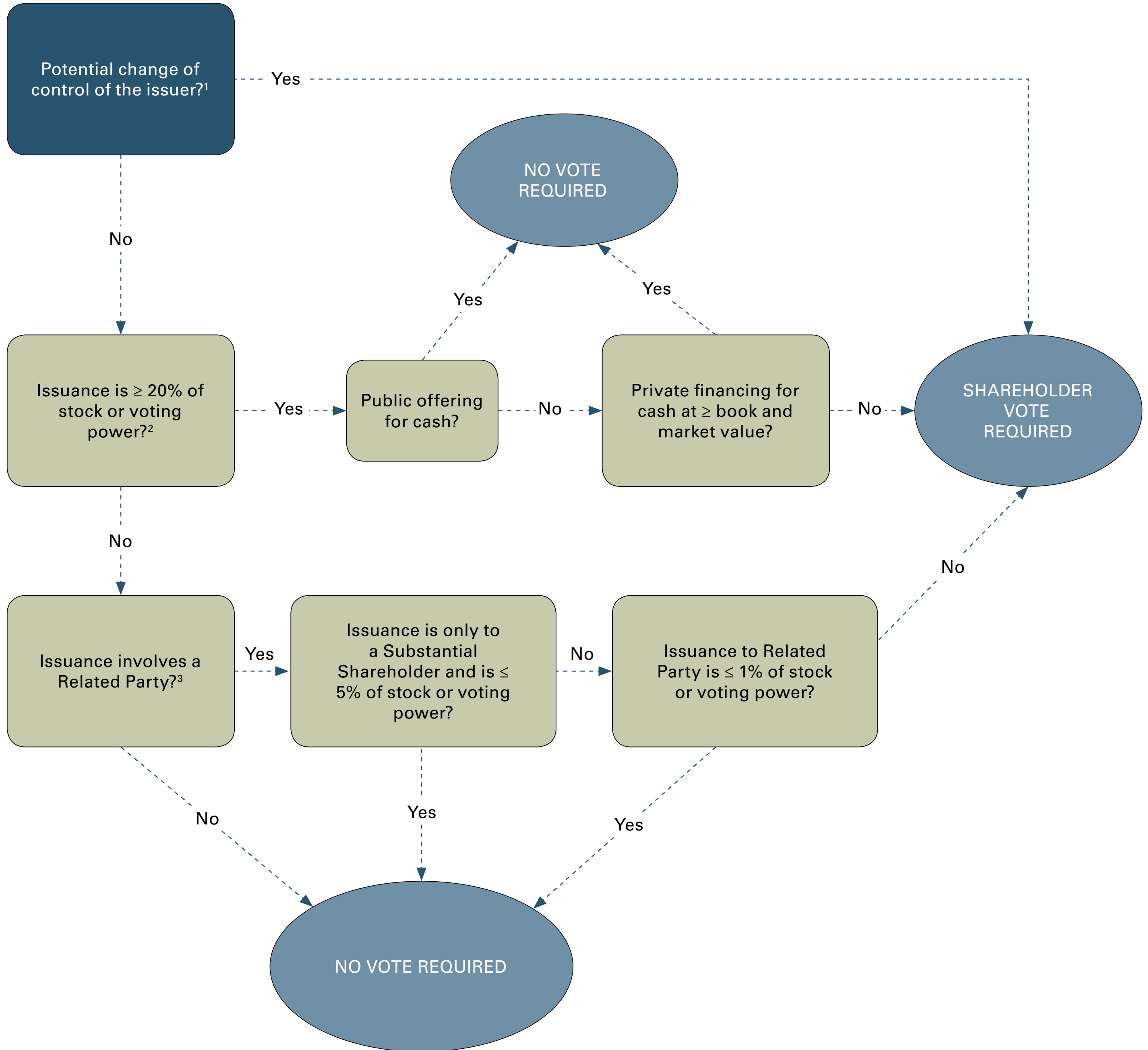
The NYSE has been known in the past to permit one-for-one exchanges of different classes of stock to occur without a shareholder vote, even if such exchange is for greater than 20 percent of the issued and outstanding common stock of the company or with a related party and would therefore otherwise implicate the vote requirements. For the NYSE to waive the vote requirement, the exchange transaction generally must not alter the relative economic rights of the stockholders (*i.e.*, the ownership and voting power of the stockholders on a fully diluted basis after the exchange must match the ownership and voting power of the stockholders before the exchange occurred). The dilution associated with the new securities also can be greater than that associated with the old securities so long as the additional dilution does not exceed 19.99 percent.

Conclusion

NYSE- and NASDAQ-listed issuers seeking to access the equity markets must give thought to certain features of their contemplated transaction, lest they run afoul of their exchange's shareholder vote provisions. Special care must be taken if the proposed transaction involves a relatively large amount of common stock or voting power, convertible securities, a potential change of control or related parties. Issuers confronting these situations should contact their counsel to structure their issuance around these and other exchange provisions as well as applicable federal securities and state corporate laws. Regardless of the situation, issuers are strongly encouraged to involve their counsel and NYSE or NASDAQ representative early in the transaction process to facilitate compliance with their exchange's shareholder approval rules.

(continued on the next page)

NYSE

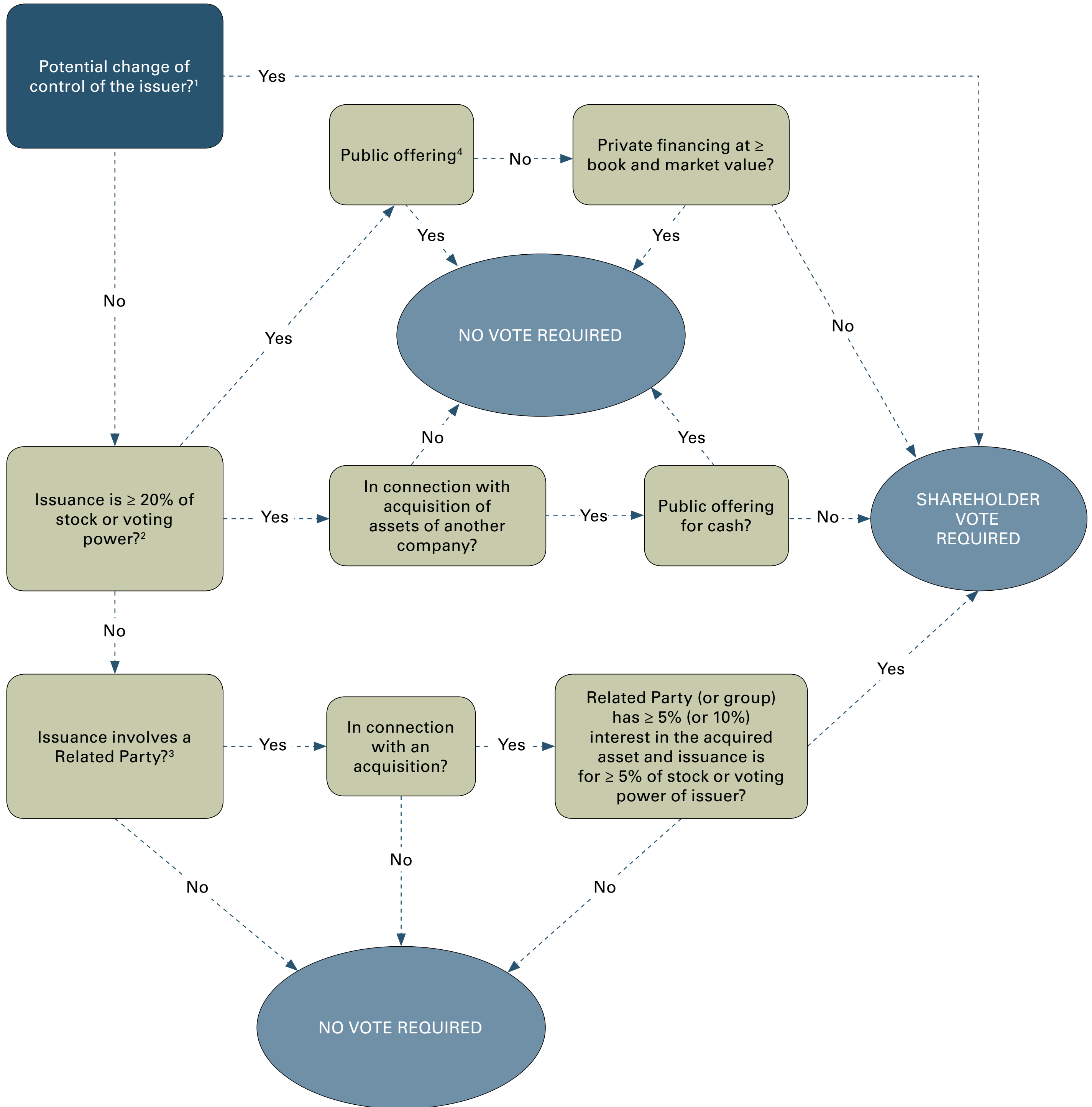


[1] NYSE 312.03(d).

[2] NYSE 312.03(c).

[3] NYSE 312.03(b).

NASDAQ



[1] Nasdaq 5635(b); see also Nasdaq Staff Guidance, November 27, 2009.

[2] Nasdaq 5635(a)(1) and Nasdaq 5635(d)(1) & (2).

[3] Nasdaq 5635(a)(2).

[4] Nasdaq 5635(d).

END NOTES

1 The NYSE also provides exemptions from the shareholder approval requirements for limited partnerships and foreign private issuers, other than those required for equity plan approval. NASDAQ also provides exemptions for foreign private issuers that elect to follow their home country rules (see NASDAQ Stock Market Rule 5615(a)(3)). *This memorandum does not address all instances where shareholder approval is required by the NYSE and/or NASDAQ, such as for adoption of equity compensation plans.*

2 NYSE Listed Company Manual Section 312.03(c); NASDAQ Stock Market Rule 5635(d). Note that the issuance of shares from treasury is included in calculating the number of shares being issued, but not in calculating the number of shares outstanding.

3 NYSE Listed Company Manual Section 312.03(c).

4 NYSE Listed Company Manual Section 312.04(g). Regarding sales to a registered broker-dealer, the NYSE has provided oral guidance that the broker-dealer acting as initial purchaser can receive a reasonable market discount from the market price so long as it resells at a price at least as great as book or market value. Sales to multiple purchasers also would need to comply with NYSE Listed Company Manual Section 312.03(b), which restricts issuances involving related parties, so most affiliates would be limited to a 1 percent purchase.

5 NASDAQ Stock Market Rules 5635(d)(1) & (2). The NASDAQ rules state that a "Substantial Shareholder" is someone holding an interest of 5 percent or more of the outstanding common stock or voting power of the issuer or party (NASDAQ Stock Market Rule 5635(e)(3)).

6 NASDAQ IM-5635-3.

7 The conversion price may be calculated by dividing the principal amount of the notes (typically $1,000 per note) by the conversion rate, which is the number of shares issuable upon conversion of each note.

8 NYSE Listed Company Manual Section 312.03(b).

9 Technically, the NASDAQ rules define "Related Party" by reference to Regulation S-K Item 404.

10 The rules do not state that the multiple Related Parties must be working together in order to have their interest aggregated.

11 NASDAQ Stock Market Rule 5635(d).

12 See, *e.g.*, the NYSE's decision in the 2005 transaction involving Banco Santander of Spain, Sovereign Bank and Independence Community Savings.

13 NYSE Listed Company Manual Section 313.

14 See https://listingcenter.nasdaqomx.com/Show_Doc.aspx?File=FAQsCorpGov.html.

15 For a group to exist, the shareholders must have filed a notice (*e.g.*, a Schedule 13D) that they are acting as a group. Staff guidance November 27, 2009, https://listingcenter.nasdaqomx.com/Show_Doc.aspx?File=FAQsCorpGov.html.

16 Staff guidance November 27, 2009. The NASDAQ rules do not state whether the calculation used to determine the "largest ownership position" will treat each investor singly or will aggregate all the ownership positions held by a group. https://listingcenter.nasdaqomx.com/Show_Doc.aspx?File=FAQsCorpGov.html.

17 Staff guidance November 27, 2009, https://listingcenter.nasdaqomx.com/Show_Doc.aspx?File=FAQsCorpGov.html.

18 NYSE Listed Company Manual Section 312.05; NASDAQ Stock Market Rule 5635(f).

19 Current Report on Form 8-K filed by The Bear Stearns Companies Inc.; March 24, 2008. As part of the sale, Bear Stearns proposed to issue more than 20 percent of its outstanding common stock to JPMorgan Chase and, therefore, without an exception, would have been forced to delay the sale transaction until it had been approved by shareholders. Instead, Bear Stearns utilized the exception in order to complete the transaction quickly.

20 Abstentions count as votes cast, but broker nonvotes are not counted (a broker nonvote occurs when a broker's beneficial-owner customer does not provide voting instructions). Accordingly, shares present at the meeting equal the sum of shares voted "for" and "against" and abstentions, and the proposal is approved if the votes "for" exceed the combined total of the votes cast "against" or as abstentions.

21 NYSE Listed Company Manual Section 312.04(d); NASDAQ Stock Market Rule 5635(e)(1).

22 NYSE Listed Company Manual Section 313(a) and NASDAQ Stock Market Rule 5640.

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