In today’s capital markets, where variety and ingenuity rule the day and there is no shortage of capital raising alternatives for use by public company issuers, confidentially marketed public offerings (CMPOs) have acquired and solidified the role of the preferred capital raising vehicle for many small-to-medium cap public companies that require consistent access to the public markets to sustain their R&D and operational needs. The CMPO represents a significant evolutionary advance in the registered offering process that allows greater “shelf” registration utilization and sophisticated pre-marketing of the offering, and employs specialized underwriting and legal techniques. This approach to capital raising is attractive because of its minimal market impact, short time to completion, low cost of execution, and adaptability to changing market circumstances, all of which allow a public company to access an opportune market window to execute a capital raise and do so quickly or, if need be, to abandon the offering altogether, without any material market consequence or pressure on its stock. In addition, the speed at which a CMPO is completed allows public companies to mitigate the adverse market effects of the shorting activities that sometimes result from an announcement of a pending public offering. The securities sold in a CMPO are freely transferable and immediately tradable, which effectively minimizes the liquidity discount incurred by public companies as compared to a private investment in public equity (PIPE) or similar private transaction.

The purpose of this article is to outline key transactional, regulatory, diligence, compliance and other related aspects of the CMPO offerings.

The CMPO Mechanics

In a typical CMPO, the public company (issuer) engages a registered broker-dealer to act as underwriter of the offering pursuant to an effective Form S-3 “shelf” registration statement. The underwriter then approaches a discrete number of institutional investors that may have an interest in purchasing the issuer’s securities. Without identifying the issuer, the underwriter asks each potential investor if it wants to be “brought over the wall,” i.e., whether it is interested in receiving confidential information about the issuer and its offering and whether the investor is willing to agree not to trade in the issuer’s securities until the offering is concluded or abandoned. If the investor’s response is affirmative, then the issuer’s identity is revealed and negotiations take place among the investor(s) and the issuer and its underwriter regarding the parameters of a transaction acceptable to the investor(s), i.e., the extent of any discount from the

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1 According to PlacementTracker, in 2012, companies raised more than $4.7 billion in more than 100 CMPOs.
2 During the past ten years there have been significant changes to the federal securities regulatory scheme that have given rise to a host of new capital formation vehicles. The CMPO, arguably, is the most sophisticated and the most flexible of those vehicles.
market price, whether warrants are involved, and the terms of the warrants. There is no public announcement and, generally, neither a preliminary prospectus nor a free writing prospectus (FWP) is used, thereby avoiding any signal to the market that an offering is imminent. Once the issuer and the institutional investors agree on the basic terms of the offering, the offering is “flipped” from a confidential offering into a public offering shortly before pricing, and a retail component is added to the offering. At that point, a prospectus supplement as well as a FWP, if any, a Securities and Exchange Commission (SEC) Rule 134 press release, and a Form 8-K containing the offering description and underlying form transaction documents are prepared and filed with the SEC after the market closes and the offering becomes a matter of public knowledge. That is when the public offering phase of the CMPO commences. This phase may be completed over the course of the next trading day, or, at times, even on an overnight basis, such that the offering may be finally priced and announced before the market opens. Then, a CMPO follows the settling and closing routine of a traditional firm commitment underwritten public offering, i.e., is generally completed (or “all sold”) overnight, and closes on a T+3 basis.

As stated above, the CMPO is appealing to issuers, institutional investors and underwriters alike. Focused marketing efforts initially targeted at a handful of institutional investors allow an issuer to complete a CMPO within a very compressed timeline (generally, within a week), which is increasingly important as market conditions can and often do change overnight. Moreover, a CMPO allows the issuer to test the market for an offering confidentially, without subjecting the market price of its stock to the often substantial pricing pressure resulting from the announcement of a pending offering. Because public announcement immediately precedes completion of the sales process (typically, no more than one or two evenings), the adverse effect on market price for the issuer’s stock usually associated with a traditional public offering is mitigated. Moreover, if the offering is abandoned for lack of interest, the adverse price effect normally associated with an abandoned public offering is avoided because the market was never aware of the issuer’s efforts to conclude an offering.

Confidential Marketing – Techniques and Caveats

The popularity of the CMPO is largely due to the confidential nature of the initial phase and the overnight element of the public offering phase. Occasionally termed “pre-marketed” or “wall-crossed,” these public offerings are registered with the SEC on a short-form Form S-3 shelf registration statement and are marketed confidentially for a short period of time to a pre-select group of institutional investors, without public announcement, as outlined above. Subsequently, the offering is “flipped” into a public offering immediately before it is priced to satisfy applicable exchange listing requirements of a “public offering.”

It is crucial that marketing efforts in a CMPO remain confidential until such time as the offering is “flipped” into a public offering. This, in turn, requires confidentiality agreements with prospective investors to avoid premature disclosure of a pending offering and to maintain compliance with Regulation FD (Fair Disclosure), and to preclude an “over the wall” investor from trading while in possession of the material non-public information. Though oral understandings are not unusual in these circumstances, public companies are best served to have written agreements to ensure the confidentiality restrictions and avoid an after-the-fact dispute as

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3 Preliminary prospectuses and FWPs must be filed with the SEC and are publicly available.
to the scope of the restrictive covenants\(^4\). To the extent the issuer determines to proceed with an oral confidentiality agreement, it still should be subsequently confirmed in writing, which could be accomplished by means of a one-way confirmatory email or an email that requires a response from the person to whom information regarding the offering will be disclosed. As an added step to ensure confidentiality before a confidentiality agreement (whatever the form) is received, an issuer should script and limit any information presented to potential investors by the issuer’s investment bankers such that it could not reasonably be used to identify the issuer.

Once “over the wall,” potential investors usually obtain immediate access to material, non-public information about the issuer, its operations and financial statements, and the contemplated offering. Generally, marketing documents for a CMPO are limited to an issuer’s Exchange Act periodic filings (i.e., Forms 10-K, 10-Q and 8-K reports), general “road show” investor presentations or other written materials, such as a term sheet describing the offering. The key to the successful execution of a fast-paced CMPO is planning ahead and anticipation of all required and optional filings, e.g. Form 8-K, prospectus supplement or FWP, term sheet, press release, as well as consideration of issuer’s internal restrictions with respect to trading, communications and insider participation policies.

**Diligence Matters**

Notwithstanding their hybrid nature, CMPOs are not all that different from the traditional, underwritten public offerings from a diligence prospective. Underwriters have the same due diligence obligations as they have in any other public offering, including the need to obtain securities and regulatory assurance or legal opinions and “comfort” letters from the issuer’s advisers and accountants. In order to accommodate the CMPO timeline, the due diligence effort is transformed into a whirlwind of activity compressed into a very short time period, and the diligence obligations imposed by Sections 11 and 12 of the Securities Act can be difficult to fulfill. Obviously, the level of diligence will vary from transaction to transaction depending on the extent of the underwriter’s familiarity with the issuer.

**“Baby Shelf” Registration Compliance Matters**

Form S-3 is the “short form” registration statement that domestic issuers satisfying certain eligibility requirements can use to register securities under the Securities Act. The Form allows incorporation by reference of the issuer’s Exchange Act periodic filings before and after the effective date of the registration statement, which in practice reduces the time intensity involved in preparation of (and the actual the length of) the registration statement considerably and eliminates the need for post-effective amendments after the effective date to update financial and other information. The Form was previously limited to issuers having a public float (i.e., voting and non-voting common stock of the issuer held by non-affiliates) of at least $75 million\(^5\). Originally, the public float requirement was designed to protect investors by ensuring that only issuers that were well established, actively traded and widely followed in the market would enjoy the benefit of registering their offerings on this short-form registration statement. Following the SEC’s liberalization of the Form S-3 eligibility requirements, this Form may now be utilized by a

\(^4\) It is not unusual for certain institutional investors to require, as a condition of their receiving such material, non-public information, that the issuer agree to issue a public announcement or an Form 8-K filing (sometimes referred to as the “cleansing 8-K”) to release such investors from the trading restrictions if the offering is not consummated, which, in turn, would allow such investors to return to their usual trading activities in the issuer’s securities, if any.

\(^5\) See Instruction B.1 to the Form S-3.
reporting company with less than $75 million in public float to register a primary offering of securities provided it meets the other registrant eligibility conditions for the use of Form S-3, and is not a “shell” company and has not been one for at least 12 calendar months before filing the registration statement. So, if a smaller reporting issuer meets the Form S-3 eligibility and transaction requirements, it may, using the Form, sell up to one-third of the aggregate market value of its public float during any given 12-month period.

The most complicated and, at times, downright confusing, element in this process is ascertaining the precise amount of securities that may be sold pursuant to Form S-3. In a nutshell, there are two basic steps of this calculation to bear in mind: (i) determination of the issuer’s public float immediately prior to the contemplated offering and (ii) aggregation of all sales during the previous rolling 12-month period (including the contemplated offering) to determine whether the one-third cap would be exceeded. In case of securities convertible into or exercisable for common stock, such as convertible debt or warrants, the issuer must calculate the amount of securities it may sell in any period of 12 calendar months by reference to the aggregate market value of the underlying common stock based on the maximum number of shares of common stock into which the convertible securities sold in the prior period of 12 calendar months are convertible as of a date within 60 days prior to the date of the contemplated offering, multiplied by the same per share market price of the registrant’s equity used for purposes of calculating its public float. Notably, the determination of the public float may be based on any date in the 60 days prior to the proposed sale. Following this calculation, the issuer will determine its ability to utilize the “shelf” registration statement as the issuer’s public float changes over time.

Exchange Listing Compliance Matters and Timing

Yet another compelling feature of the CMPO is the built-in mechanisms and techniques that allow issuers to address regulatory limitations imposed under the continued listing requirements of the major U.S. securities stock exchanges (Exchanges). The CMPO effectively navigates through these limitations which, at times, pose significant impediments to other kinds of shelf takedowns, i.e., the ones that do not involve a wide public distribution, such as an institutional investor-only shelf takedown. For example, an issuer cannot sell securities representing 20 percent or more of an issuer’s voting power if the securities are sold at a discount to market value without a shareholder vote (and institutional shelf takedowns are generally concluded at a discount to the market price). By satisfying the Exchange definition of “public offering,” which can be accomplished in the public phase of the CMPO, the issuer is free to sell an unlimited amount of its securities.

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6 See Instruction B.6 to the Form S-3. The issuer will not be subject to the one-third cap limitation should its public float increase to exceed $75 million after the effective date of the registration statement. However, if the public float falls below $75 million at the time that its next Annual Report is filed, the cap will be reinstated. In contrast, issuers that meet the $75 million threshold at the time the Form S-3 is filed will not be subject to the one-third restriction, even if their public float falls below $75 million after the effective date, but prior to such issuer’s next Annual Report at which time its eligibility must be re-evaluated.
As discussed above, the continued listing requirements of the Exchanges\(^7\) require shareholder approval for any offering representing 20 percent or more of an issuer’s voting power if the securities are sold at a discount to market value (which often occurs with CMPOs albeit at less of a discount than many other forms of financing) and are not sold in a “public offering\(^8\).” In this context, the meaning of the term “public offering” is crucial, i.e., not every registered firm commitment underwritten offering will be deemed a “public offering.” The determination is a fact-specific inquiry that involves the Exchange staff’s consideration of a number of relevant factors, none of which are dispositive. These factors include, among others:

- **the type of offering in question** (e.g. firm commitment, best efforts or issuer directed) – as a matter of guidance, firm commitment offerings are viewed more favorably than other types of underwriter/placement agent involvements;
- **the nature and breadth of the marketing efforts** (e.g. number of investors approached and offered the issuer’s securities, investor prescreening techniques used and overall breadth of the effort) – although there is no magic number/ratio, the Exchanges look to see active marketing outreach to a healthy mix of investors;
- **the extent of distribution involved** (e.g. number and identity of the investors (institutional vs. retail));
- **the offering price** (discount to the market price, if any); and
- **the extent to which the issuer controls the offering and its distribution.**

The Exchange staff must review the terms of any contemplated offering to ascertain compliance with its rules and regulations. It comes as no surprise, therefore, that the Exchange staff encourages listed companies to engage the staff review as soon as practicable, even if it is highly likely that the offering terms will change.

In addition to the “public offering” rule that is often triggered in the CMPO context, the issuer must also be mindful of two additional continued listing requirements that may be implicated in connection with a CMPO. One issue pertains to the Nasdaq rule relating to the shareholder approval requirement prior to any sale or potential sale of securities that may result in a change of control of the listing entity\(^9\). The second issue that arises relates to insider participation in the offering. Nasdaq rules require shareholder approval prior to the issuance of common stock to directors, officers, employees, consultants or affiliates at a price less than the current market price\(^10\). Both of the “change of control” and “insider participation” rules have a “public offering” exemption, i.e., to the extent the issuer is engaged in a bona fide public

\(^7\) For the ease of reference, this article focuses on and references the applicable continued listing requirements of the Nasdaq Stock Market. Generally speaking, the applicable rules of the NYSE and NYSE MKT do not result in a different outcome from those under the Nasdaq Stock Market.

\(^8\) Nasdaq Stock Market Rule 5635(d). Noncompliance with the foregoing listing requirement could result in a listing deficiency notification, a reprimand or a possible delisting of the issuer’s securities.

\(^9\) Nasdaq Stock Market Rule 5635(b).

\(^10\) Nasdaq Stock Market Rule 5635(c).
offering, meeting the criteria discussed above, neither of these additional Nasdaq restrictions are implicated\textsuperscript{11}.

So, with all of the foregoing limitations in mind, once the indications of interest have been obtained during the confidential marketing phase of the CMPO, if the 20 percent offering limitation is an issue and/or in order to comply with the Exchange continued listing guidance to meet the “public offering” parameters, the issuer will need to coordinate with the Exchange staff to assure that the CMPO will be treated as a “public offering.”

\textbf{FINRA Corporate Financing Rule Compliance}

In 2010, FINRA upgraded its review of corporate filing procedures and introduced a same-day clearance process for many registered offerings which streamlined and, undoubtedly, significantly contributed to the attractiveness of CMPOs as an expedient financing vehicle. This fast-paced process requires certain issuer- and filing-specific information as well as certain representations from the issuer. The same-day clearance process applies to both the “base” prospectus and prospectus supplement filings. Here, a practice point is in order. During the preparation and filing of the Form S-3 “shelf” registration statement, the issuer counsel should be mindful to include certain FINRA-mandated language pertaining to the aggregate value of underwriter compensation in the \textit{Plan of Distribution} portion of the “base” prospectus. In effect, the language should state that the aggregate value of all compensation to be received by participating FINRA members will not exceed 8 percent of the offering proceeds. This simple step will save the issuers a great deal of regulatory review time and potential frustration in the course of the FINRA Corporate Financing Rule 5110 review and clearance.

\textbf{Conclusion}

Companies that have a periodic need to access the capital markets should investigate the CMPO as a vehicle for capital formation. In light of the intricacies and complexities of CMPOs, an issuer contemplating a CMPO would be well advised to familiarize itself with the parameters, timeline, mechanics and regulatory implications of a CMPO, and ensure that their advisers, and, particularly, legal counsel, are well-versed in these transactions.

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\textsuperscript{11} The practice has shown that the Exchanges tend to carefully evaluate the insider participation element in any public offering and will generally inquire into the details and background of such participation.