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Private Placements In Public Equity (PIPEs): Best Practices for FINRA Members[1]

We have prepared this Memorandum in order to provide interested parties (including member firms of the Financial Industry Regulatory Authority (FINRA)) with guidance as to best practices and procedures relating to a common private financing vehicle for existing publicly-traded companies known as the "PIPE" or "private investment in public equity." Other market participants such as issuers and investors will hopefully find this Memorandum useful as well.

In a PIPE, an issuer, either on its own, but very often with the assistance of a FINRA member broker-dealer, sells securities (which could consist of common stock, preferred stock, convertible notes and/or warrants to purchase common stock) in a private placement and agrees with the investors in connection with such sale to subsequently register the privately placed securities (or the common stock underlying convertible securities like preferred stock and notes) for public resale on a registration statement filed with the Securities and Exchange Commission (SEC). This allows the investors (once the registration has been reviewed and declared effective by the SEC) to sell the securities received in the private placement in a public market – thus, a private investment in a public equity. The benefit of a PIPE is to be able to raise money relatively quickly in a private sale (versus registering the offering to investors with the SEC first), and also has the benefit to investors of given them an opportunity for liquidity in the public markets.

By their nature, these suggestions are intended to be broad guidelines and are not exhaustive of the various details that are required to effectuate any proposed financing engagement. Additionally, while most PIPE engagements have similarities, readers are advised that there are also many differences (for example, securities being offered, type of issuer as well as investor profiles), and consequently, specific guidance must be taken on the particular facts of each transactions.

Part I.
Policies and Procedures Regarding the Implementation of a PIPE

PIPEs are generally structured and marketed in two different ways – the "Retail PIPE" and the "Institutional PIPE." A Retail PIPE is a financing being marketed to both institutional and individual investors. An Institutional PIPE is a financing being marketed solely to institutional investors, and is usually initiated by a term sheet sent by the placement agent to potential investors.

Preparation of the documentation for the PIPE depends upon the type of PIPE. Usually in the Retail PIPE, the FINRA member firm's counsel and counsel to the issuer prepare all of the documents. In the Institutional PIPE, the member firm and its counsel prepare the engagement letter and term sheet. Often the investors may have their own counsel prepare the actual transaction documents.

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1 This Memorandum is presented for informational purposes only. It does not constitute legal advice, nor does it create an attorney client relationship. We strongly advise that you discuss the issues raised in this Memorandum with legal counsel. This guide may be considered attorney advertising in some states.

Notwithstanding that the lead investor in the Institutional PIPE often prepares the transaction documents, we recommend that FINRA member firms retain counsel in every Institutional PIPE to ensure that the disclosure documents contain proper disclosure and that required due diligence under FINRA rules is undertaken.

Engagement Letter and Global Non-Disclosure Agreement

No engagement of a FINRA member firm for a PIPE should commence without an executed engagement agreement (including standard indemnification provisions) with the issuer. Additionally, FINRA firms should have in place a Global Non-Disclosure Agreement (NDA) with its PIPE investor client base and as new clients are obtained. This agreement must be executed prior to the release of any information regarding a specific PIPE and allows the FINRA firm to bring investors "over the wall" to learn about the existence of a potential financing. Without this in place, there may be violations of the SEC's Regulation FD, which prohibits the selective disclosure of non-public information (including the existence of a potential financing for a company). See more on Regulation FD below. When presented with any specific PIPE opportunity, the targeted investor should acknowledge its NDA obligations. We recommend this procedure because a Global NDA avoids timing delays associated with obtaining non-disclosure agreements for each PIPE.

While the standard engagement agreement between an issuer and its FINRA member placement typically has fairly standard provisions, we would also recommend adding provisions for the benefit of a FINRA member which: (i) restrict directors, officers and placement agents (and their employees, etc.) from investing in the PIPE (to avoid conflicts of interest and FINRA concerns about allocations) as well as adding appropriate lock-up periods for such persons; (ii) contain obligations of the issuer to cooperate with the placement agent with respect to any required FINRA filings (most notably, for FINRA review of compensation in connection with any resale registration statement filed following the PIPE); and (iii) restrict the issuer's ability to go back to the PIPE investors for further financing without compensation to the FINRA firm (the so called "fee tail," which is often hotly negotiated).

Investor Documents

An Institutional PIPE is initiated by a term sheet sent by the placement agent to potential investors, along with reference to the subject issuer's periodic filings with the SEC. We would recommend that accompanying the term sheet should be a detailed executive summary as well as meaningful risk factors regarding the issuer. Many placement agents market Institutional PIPEs with just a power point presentation—we would recommend including risk factors here as well and limit this practice to only true institutional investors such as hedge funds and other institutional investors. The final transaction terms (such as the price to be paid by investors and any investor rights) are typically memorialized in a direct securities purchase agreement, a registration rights agreement and related documentation. This documentation is executed when funding occurs.

The Retail PIPE should include a detailed private placement memorandum, subscription documents and a set offering period. The placement agent should also execute a placement agency agreement with the issuer which usually will contain representations and warranties and many covenants similar to an underwriting agreement.

We also recommend that a separate escrow account to hold investor funds prior to closing be utilized for the transaction. Although under FINRA and SEC rules (SEC Rule 15c2-4) an attorney account or separate FINRA member firm account may be acceptable in certain circumstances, we recommend that a third party bank escrow agent be used. If the PIPE transaction has offering

contingencies (such as a minimum amount to be raise before a closing can occur, or closing is subject to completion of an acquisition), a separate escrow account is required and it may not be maintained by counsel to the issuer or the member firm.

Due Diligence

FINRA has for several years provided guidance that any FINRA member firm that engages in financing activity (event private placements) has an obligation to its investors to have conducted due diligence. FINRA has publicly stated that there is no difference in the type of due diligence required in Retail PIPES and Institutional PIPEs. This obligation emanates from the member firm's "suitability" obligations. Suitability is a two part standard and requires the member firm to (a) know its customer and (b) have a basis to recommend the proposed investment to the customer. The level that we believe satisfies this admittedly vague standard is a review of all recent public filings (such as 10-Qs, 8-Ks, Annual Reports and Proxy Statements).

Certain PIPE investors will ***not*** want to partake in any due diligence related to the issuer other than publicly available information because they believe it preserves their ability to trade. We recommend that the member firm's banking staff be aware of, and advise its PIPE investor client base of the many actions initiated by FINRA and SEC against PIPE investors and placement agents alleging trading on inside information. Both the SEC and FINRA have taken the position that in most situations, the existence of the PIPE is a material non-public event and therefore anyone with knowledge of the PIPE who trades would be trading on the basis of material non-public information. See the discussion below under "Part II. *Additional Regulatory Issues."* If the PIPE investor does not obtain any material non-public information, it should be able to trade in the securities of the issuer after the PIPE is announced or abandoned. This is why the NDA has become an important part of the PIPE structure.

For Institutional PIPEs or financings associated with an acquisition (where no public information is available regarding the acquisition target), consideration should be given to establishing a virtual data room with regard to due diligence. This enables the issuer and placement agent to keep tabs on who views the data, when a particular entity or person views the data or prints the data. The fact that a FINRA firm or issuer can audit who views data may serve to highlight areas of interest regarding the particular transaction (which while not usually important in the financing portion of the transaction, has implications in the mergers and acquisition context). Generally, the data room increases the efficiency of a transaction as it allows authorized users to review due diligence documentation in real time as it is posted. A customized due diligence request list should be submitted to the issuer in order to obtain and review documents in connection with the transaction. Depending upon the scope of the request, the virtual data room may provide the most manageable method to store, review, and maintain documents.

We believe that the parameters for due diligence should be specifically tailored depending upon the transaction. Strong consideration should be given to background checks should be obtained on all key operating personnel and "promoters." We strongly advise that the member firm's banking staff visit the primary operating facilities of the issuer and conduct interviews of all of the key operating executives. Usually these steps are taken prior to engagement of the member firm while the terms of the engagement and the potential financing structure are being negotiated.

Part II.
Issues of Concern in Implementing a PIPE

In structuring an implementing a PIPE, consideration should also be given to other issues for purposes of gaining a better understanding of any complications that may arise from the proposed PIPE and its subsequent registration.

Shareholder Approval

Listed public companies (NASDAQ, NYSE and NYSE MKT (formerly the AMEX)) are required to obtain shareholder approval prior to the issuance of PIPE securities if the amount of common stock issued (or the ultimate amount issuable as a result of any conversion) exceeds 20% of the issuer's outstanding stock (not fully diluted), unless the stock is issued at a price that equals or exceeds the market value of the stock. Additionally, if officers or directors are buying shares in the transaction that is priced below market value, NASDAQ requires prior shareholder approval unless the offering doesn't exceed the lesser of 1% of the outstanding stock or 25,000 shares. Each of the listing authorities also maintains the right to review recent transactions prior to the listing application and has indicated that they will not permit listings where a financings of more than the 20% was concluded immediately prior to or contemporaneous with the listing request.

Therefore, we recommend that the FINRA member firm's staff thoroughly analyze the issuer's capitalization prior to negotiation of the initial term sheet, and certainly prior to execution of any definitive documents, to ascertain whether shareholder approval is going to be required.

Primary Underwriter Liability

In the past, the SEC has raised challenges during the PIPE resale registration process regarding the ability of the issuer to rely upon SEC Rule 415 for the proposed resale of the PIPE securities. In essence, when a PIPE involves a large amount of the outstanding common stock of an issuer and/or involves one or a very small group of investors, the SEC has from time to time question whether the proposed resale registration statement is not a really secondary offering at all, but actually a primary offering by the issuer. In this regard, the SEC has requested that the PIPE investor(s) be named as an underwriter and that an offering price and a set offering period be set forth in the registration statement. It is important to note that the SEC staff has not issued any official statement in this regard.

Due consideration must be given by the FINRA member firm, and communicated to the potential PIPE investors, of this new SEC area of focus. Based upon communications our firm has had with SEC staff over the years, the following "facts" are relevant to whether the SEC will "challenge" or at least question, the resale registration statement:

- the percentage of shares being registered in the PIPE registration statement compared to the capitalization of the issuer (the potential for inquiry appears to increase if above 30%);

- the number of PIPE investors (usually one or a small number could lead to questions about whether the investors are in effect acting to resale to the public the securities sold to such investors in the PIPE, just as would happen in a traditional underwritten offering);

- whether the issuer has previously conducted an underwritten public offering or is the resale registration the first "public offering";
- how long the PIPE selling security holders have held their securities; and
- whether the PIPE investor(s) ares in the business of underwriting.

Integration of Public and Private Offerings

In a PIPE, particular sensitivity must be paid to the "integration doctrine." The integration doctrine provides an analytical framework for determining whether multiple securities transactions should be considered the same offering or a public offering, resulting in the issuer violating the private placement rules. The SEC looks at the following factors when determining whether two or more offerings should be integrated: (i) whether the two offerings are part of a single plan of financing; (ii) whether the two offerings are for the same class of securities; (iii) how close together the two offerings are in time; (iv) whether the same type of payment for the securities is being received in both offerings; and (v) whether the two offerings are for the same general purpose. As such, in each PIPE (really in any private offering, or in any public offering), consideration needs to be given to whether the present offering could be considered integrated with another offering which, in turn, could lead to the failure of an offering and the right of investors to receive back any funding they have provided to the issuer.

Although in recent years, the integration doctrine has been liberalized by the SEC, particularly with the advent of "private" offerings that permit general solicitation to the public, the concern remains significant. One of the biggest hindrances to pursuing a Retail PIPE is whether there is an "open registration" on file with the SEC (i.e., a registration filed but not yet declared effective). The SEC has previously allowed some forms of Institutional PIPEs for an issuer notwithstanding that there may be an open registration, and although there are established safe harbors, it is wise to have counsel review the issuer's previous and proposed financings to determine whether the offerings will be integrated or whether there is an applicable safe harbor, as there are a number of eligibility qualifications.

Confidential Treatment Request

During the due diligence process, a determination should be made as to whether the issuer has (or intends) to submit a confidential treatment request (CTR) with the SEC. Although the rules indicate that only a pending CTR with respect to an S-3 will delay the effectiveness of that registration until the SEC has either cleared or denied such CTR request, the SEC applies this rule to all registration statements. Consequently, any resale registration will be "held up" until the CTR is processed. The investor documentation should obtain a representation from the issuer that no CTRs are pending. If the CTR requested is pending at the time of the PIPE, the PIPE documents, especially the registration rights agreement, will have to reflect the potential delay of the effectiveness of the registration.

Part III.
Additional Regulatory Issues

Regulation FD:

Regulation FD is generally an obligation of the issuer. However there are certain broker-dealer sensitivities with regard to Regulation FD that relate to PIPEs when the firm is acting as placement agent or selling agent. Regulation FD prohibits the selective disclosure of material non-public information by

public companies. Under Regulation FD, a public company that intentionally discloses material non-public information must do so in a fashion designed to effect public dissemination of the information. In many situations, particularly small and micro cap companies undertaking a PIPE, the terms of the PIPE may well constitute material non-public information. As a result, companies engaging in such transactions should obtain either non-disclosure agreements (as discussed above) or refrain from providing any material non-public information to the investors. While we are reminding member firms that they have a due diligence obligation with respect to each issuer that they are undertaking, sensitivity to obtaining too much information must also be a concern for fear of gaining access to information that will not become public, and consequently, restrict the investors' trading. The objective in a PIPE is to ensure that an investor is not limited from trading once news of the financing has been announced, although there may still be other regulatory issues preventing immediate trading. If the financing is accompanying an acquisition, trading may be curtailed until the filing of the proxy materials or a later date.

A FINRA member firm should attempt to avoid being an indirect conduit for the selective dissemination of material information. The obtaining of the NDA is an important step in this direction. We also recommend that the member firm decline to process any trade in the PIPE issuer's securities for any client who has received information regarding the PIPE until public dissemination of the PIPE terms have been made by the issuer.

Hedging

PIPE investors may want to hedge their investments by shorting the common stock in an amount equivalent to their purchase in the private placement, as the public announcement of a PIPE can cause a decline in the market price of the common stock. However, this practice is frowned upon by the regulators and could very well be unlawful. Typically, the regulators will argue that such an investor has misused material non-public information if the investor engages in such hedging activity. In the event that no confidentiality agreement is executed, the regulators may argue that the investor violates the investment intent of the private placement by engaging in hedging, or might allege a fraud on the market theory. Additionally, regulators will look to whether the placement agent has acted in concert with the primary violator by (a) providing the information, and (b) executing the transaction. As stated above, we recommend that for "best practices" the member firm decline to process any trade in the PIPE issuer's securities for any client who has received information regarding the PIPE until public dissemination of the PIPE terms have been made by the issuer.

Research Reports and Research Analyst Participation

FINRA member firms should consider postponing the issuance of research reports on the issuer, both immediately prior to the PIPE offering and during the PIPE offering, in order to prevent a claim that there has been general solicitation or advertisement in contravention of Section 4(a)(2) or Regulation D promulgated by the SEC[2.] Additionally, there may be Regulation M implications with regard to issuance of research reports during restricted periods (see below).

FINRA member firms must also adhere to the research analyst policies and rules implemented by FINRA to separate involvement of research staff from the investment banking process.

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2 Note, however, that recent 2013 SEC rule changes now allow issuers and their agents to engage in general solicitation, although there is a requirement that the issuer verify (usually through third parties) the accredited status of each investor. This adds a layer of burden that makes it advantageous to keep the PIPE truly "private".

Internal Chinese Wall

A "solid" Chinese Wall should be maintained with the FINRA member firm to contain information and prevent leaks of material non-public information outside of the corporate finance group into other areas of the firm. The Insider Trading and Securities Fraud Enforcement Act of 1988 (Insider Trading Act) imposes an obligation to establish policies and procedures reasonably designed to prevent the misuse of material non-public information by broker-dealers, employees, and their proprietary accounts. There should thus be a separation between investment banking and the capital markets, research and brokerage units. Investment banking transactions cannot be subject to review by, under supervision or control of the arms of the broker-dealer. With regard to retail brokerage, all communications and correspondence related to an issuer during a PIPE offering must be approved by the firm's compliance department. Information related to the issuer or the PIPE should be communicated internally only on a "need-to-know" basis. Employees with access to such information should be advised of their obligation not to disclosure such information to any person unless that person is required to know in performance of the firm's contracts and responsibilities. In the event an employee is required to "cross the wall" in the normal course of business, the compliance department should be notified and document the circumstances.

Watch List/Restricted List

The member firm must also implement a "watch list/ restricted list" policy. The member firm should place the issuer's security on the "watch list" at the time that the firm and the issuer have agreed upon the terms of the firm's engagement for the PIPE. Usually this is at the time the written engagement agreement for the PIPE is executed but it may be earlier. For example, the firm may be engaged by an issuer as an investment banking/financial advisor prior to a particular PIPE transaction being discussed. We recommend that the firm place any such security on the "watch list" at this time because it is likely that investment banking staff will have material information related to the issuer and the member firm needs to monitor the flow of any such information.

A security must be placed on the "restricted list" when the firm has been engaged for a particular transaction. In the PIPE scenario, this is usually the time when the firm enters into a written engagement letter for a particular PIPE transaction.

We recommend that the investment banking staff which is engaged in discussions with an issuer be required to report to the firm's compliance department on a periodic basis so that the compliance department can determine whether discussions have reached a stage to require that an issuer's securities be placed upon the correct list.

Compensation and FINRA Rule 5110:

FINRA Rule 5110 requires any FINRA member firm which "participates or is participating in an offering" to make a filing with the FINRA Corporate Finance Department, so that the department can review the reasonableness of the compensation received by the member broker-dealer participating in the distribution, and issue an affirmative determination regarding the proposed compensation terms.

Many member firms are not aware of this filing obligation, innocently (but falsely) believing that the transaction in question is a private placement and not subject to Rule 5110. However, Rule 5110 also applies indirectly to PIPE offerings and similar transactions, because the PIPE is commonly followed by the filing of a registration statement to allow for the resale of the PIPE securities by the investors (and perhaps the member firm, if, for example the member firm receives securities as compensation in the

PIPE). It is at the time of the filing of the resale registration that the member firm must file pursuant to FINRA Rule 5110.

The member firm must decide whether it is going to be participating in the resale of the securities by the PIPE investors. The term "participating in an offering" is broadly defined by the FINRA. This firm has been advised by the FINRA Corporate Finance staff that a member firm acting as an agency broker for clients who are selling shareholders in a resale offering, are deemed to be "participating in an offering" and therefore must make a Rule 5110 filing. In addition, the FINRA has advised that a member firm named as a selling shareholder is also deemed "participating in an offering" when it sells its shares. Without a determination from the FINRA that the proposed terms of the financing compensation is fair, an FINRA member may not participate in the offering. This means that the member firm cannot act as broker agent for the PIPE investor resales.

Fair compensation looks only at the <u>non-cash</u> compensation the member firm received as part of the PIPE. Similar to an underwritten offering, non-cash compensation can include a valuation of warrants or other securities, rights of first refusal and board seat rights. FINRA will also include the commissions earned on the agency based sales from the shelf registration as part of their calculation. Generally, fair compensation is in the range of 8% of the resale offering.

Regulation M

Compliance with SEC Regulation M is essential. Generally, Regulation M precludes distribution participants, the issuer and affiliated purchasers, from bidding for or purchasing the security being distributed outside of the offering (except through appropriate stabilization transactions) or to induce others to purchase such securities in the secondary market while the distribution is in progress. Regulation M is aimed at the manipulative impact of bids and purchases by participants while a distribution is in progress but is prophylactic in operation and does not require proof that such transactions affected the market price of the security or were engaged in with manipulative intent.

A distribution includes two elements: "magnitude" and "special selling efforts and selling methods." Factors relevant to the magnitude element are: the number of shares to be registered for sale by the issuer, and the percentage of the outstanding shares, public float, and trading volume that those shares represent. The SEC has consistently held that special selling efforts or selling methods may be indicated in a number of ways including the payment of compensation greater than that normally paid in connection with ordinary trading transactions. With respect to PIPE offerings, there is likely magnitude and special selling efforts. Special selling efforts are present by the preparation of the private placement memorandum or term sheet, as well by participating in investor meetings and presentations.

A distribution many also occur during resales from the shelf registration and the sale of the placement agent warrants. Generally, during a distribution, the firm should not engage in any solicitation to buy or sell the issuer's common stock. The firm should also cease market-making activities.

Blue Sky Issues

We suggest that any PIPE undertaken by the member firm be conducted so as to comply with Regulation D promulgated by the SEC. Although a significant amount of state review of private placements under Regulation D has been pre-empted by the National Securities Markets Improvement Act of 1996 (NSMIA) provided that there is compliance with SEC Rules and Regulations, the individual states still maintain some right to review the offering, especially for general anti-fraud issues. Other than New York, PIPE offerings conducted under Regulation D usually require post sale filings; an offer

(sending the documents) into a state does not trigger the filing obligation. It is extremely important for the member firm to understand that in any PIPE conducted with an offering contingency – such as a "minimum/maximum" – the state filing must be made when the money is first received into escrow, which is often earlier, especially in Retail PIPES, than the closing date. Prior to engaging in any offering of any security for sale in any state, a firm must review the relevant blue sky laws and take appropriate action to allow the offering to be made in that particular state. We strongly recommend that counsel to the member firm be charged with blue sky compliance to ensure that the member firm is protected by the proper and timely filing.

Conclusion

Given the complexity of the rules (SEC, FINRA and exchanges), the concept of "Best Practices" for FINRA members and other market participants engaged in corporate financing activities involving PIPEs is continually evolving. Consequently, we make the foregoing recommendations with the full knowledge that not all member firms approach PIPEs in a uniform manner. We also recognize that certain of our suggestions are more conservative than other practitioners might recommend, but we would emphasize that given the regulatory environment for this type of financing, we firmly believe that erring on the side of caution is prudent.

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