Articles + Publications | March 5, 2009

Registered Direct Offerings as Alternatives to the Traditional PIPE Offering

Corporate and Securities Law Alert

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The registered direct offering (RDO) presents an intriguing alternative for companies contemplating a private investment in public equity (PIPE), because it combines the marketing appeal of a PIPE with the pricing of an underwritten public offering, and is quicker to close than either one. While not a panacea for all financing woes, companies large and small should unholster the RDO when a tight financing window demands its flexibility.

In a PIPE transaction, a public company negotiates the sale of its securities – frequently common stock and warrants – to private investors. Because a private placement provides investors with illiquid securities, the sale is conditioned on a resale registration statement subsequently being filed with, and declared effective by, the Securities and Exchange Commission. Investors then must hold the restricted securities until the resale registration statement becomes effective, typically 60 to 90 days later. Because the shares purchased in the PIPE are not immediately transferable, investors can demand a steep discount to compensate for the illiquidity. While the discount for established, stable companies generally ranges from around 8 to 12 percent below the market price prior to the announcement of the PIPE, actual discounts vary widely, from no discount to over 50 percent in some cases, depending on the volatility of the issuer's stock and the relative negotiating leverage of the parties. Unfortunately for the issuer, the public markets tend to react negatively to a discounted sale price in a PIPE deal, and the public trading price typically falls to around, or below, the price offered in the PIPE.

The beauty of an RDO is that it combines the strengths of a PIPE with a price point similar to that achieved in a public offering. In a registered direct offering, the issuer files a shelf registration statement with the SEC in advance of the anticipated need for funding, which allows the registered shares to be taken "off the shelf" when market conditions are ideal. The company can then line up a group of investors. Investors are not required to negotiate or sign any purchase agreement; consequently, no documentation has to be completed with purchasers. This reduces legal and administrative expenses and shortens the marketing period. Because investors receive fully liquid securities, they are not in a position to demand a substantially discounted price, so the issuer avoids the dilutive effect of a PIPE transaction. The average discount offered in an RDO is only 4 to 6 percent, which helps prevent a substantial drop in the market price of the securities, in contrast to a PIPE. In short, an RDO enables an issuer to move quickly and quietly, just like a PIPE, but also delivers a reliable price.

RDOs have existed for years, but they have only recently become a preferred capital-raising technique. For smaller issuers, the increased use can be traced to SEC rule changes which became effective in 2008, aimed at making it easier to conduct a shelf registration. Under the revised rules, a company with less than $75 million in public float may file a shelf registration for a primary offering, provided they:

- meet other eligibility criteria for the use of Form S-3 (including having a class of securities registered under the Securities Exchange Act of 1934 and making timely periodic filings under the Exchange Act for the past 12 months)
- have a class of common equity securities that is listed and registered on a national securities exchange (including the NYSE, NASDAQ, AMEX or any of seven other smaller exchanges)
- sell no more than the equivalent of one-third of their public float in primary offerings in reliance upon the new relaxed eligibility criteria over the period of 12 calendar months before filing the registration statement
- are not shell companies and have not been shell companies for at least 12 calendar months before filing the registration statement.

The increased use of RDOs also can be traced, in part, to differences in regulation of RDOs as compared to PIPEs. Securities exchanges require prior shareholder approval if an issuer conducts an offering of securities other than a public offering, such as a PIPE, that results in the issuance of 20 percent or more of the issuer's total outstanding capital stock. Issuers may be able to sidestep the 20 percent rule by conducting an RDO because a properly structured RDO will be deemed a "public offering" by the securities exchanges, eliminating the need to seek shareholder approval. To be considered a public offering, the RDO must either be, or be disclosed and distributed in the same general manner as, a firm commitment underwritten securities offering. Relevant factors the securities exchanges will consider in determining if an RDO is a public offering include the number of investors, the breadth of the marketing effort, and the extent to which the issuer (rather than the underwriter or placement agent) controls the offering and its distribution.

Meanwhile, larger issuers also have turned to the registered direct offering as a preferred financing vehicle as increased competition for scarce funds has driven demand for flexibility. In much of 2008 and so far in 2009, capital market volatility has made it difficult for companies to spot and take advantage of tight financing windows. In addition, companies have worried that short sellers would deflate the issuing price in advance of an announced public offering in anticipation of a drop in the price of the securities upon completion of the offering. Under normal market conditions, security holders of large, seasoned issuers might not be spooked by a sudden drop in stock price, but with the market slowdown, even large companies were wary of leaving their capital-raising to the whims of a skittish public. In short, companies large and small have found a need for a capital-raising process that is quick and quiet. The RDO structure largely satisfies these considerations.

However, the RDO is not a cure-all. Merely filing an S-3 could spook the market if the investor relations aspect is not handled correctly. The RDO also has not been immune from the economic downturn. Even as a growing number of companies have sought to make registered direct offerings, purchasers have practically disappeared, having retreated to the sidelines in anticipation of more stable capital markets. Consequently, investors have been putting growing pressure on issuers to include warrants alongside steeper discounts in registered direct deals. Since the middle of 2007, two-thirds of registered direct deals issued by companies with market capitalization of less than $250 million have included warrants. Even large issuers are compelled to include warrants almost one-fifth of the time. While the RDO has proven better than many alternatives, it is not without its drawbacks.

The key to effective use of the RDO, of course, is early registration on Form S-3, which necessitates a different way of thinking about raising capital. The issuer cannot simply wait until it needs funds to begin thinking about how it will raise them. Given the many advantages of an RDO, it makes sense for companies to place some securities on the shelf in anticipation of a future offering.

If you are considering a public offering of securities, please contact any of the attorneys of Pepper Hamilton's Corporate and Securities Practice Group. We can assist you and your company with a wide variety of capital raising alternatives, including raising capital through a public offering registered on Form S-3.

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