Market Trends 2017/18: Confidentially Marketed Public Offerings

A Lexis Practice Advisor® Practice Note by
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OVERVIEW

A confidentially marketed public offering (CMPO), sometimes referred to as a wall-crossed offering or pre-marketed offering, is an offering that is initially marketed to specific institutional investors who may have an interest in purchasing the issuer's securities. During this initial, confidential phase, no public announcement of the offering is made and no preliminary prospectus or free writing prospectus is used. Once the issuer and initial institutional investors agree on the basic offering terms, the offering is then "flipped" into a public offering shortly before pricing so that the underwriter can market the offering more broadly to other institutional investors and to retail investors. Selling efforts may be completed over the next trading day but are often completed on an overnight basis with the final pricing and terms announced before the market opens the next day. The securities then settle and close like a traditional firm commitment underwritten public offering on a T+2 basis. For more information, see Confidentially Marketed Public Offerings.

In the several years prior to the 2008 financial crisis, a significant majority of follow-on offerings were fully marketed offerings, which can take several days to weeks to complete. Since the financial crisis, the number of fully marketed offerings has dropped significantly. From 2008 to 2014, fully marketed offering volume was cut in half and only represented approximately 32% of all follow-on offerings. From 2015 to 2017, fully marketed offering volume was cut in half again and only represented approximately 15% of all follow-on offerings.

Traditional, full marketing has been largely replaced by unannounced and accelerated offerings, such as CMPOs and bought deals. In 2015, CMPOs (completed on an overnight basis) represented approximately 25% of follow-on activity. In 2016 and 2017, overnight CMPOs accounted for approximately 36% and 33% of follow-on activity, respectively.

DEAL STRUCTURE AND PROCESS

Conducting a CMPO

To successfully conduct a CMPO, the issuer and the underwriter need to ensure the following are in place or otherwise addressed:

- An effective shelf registration statement on file with the Securities and Exchange Commission (SEC)
- A standardized wall-crossing process for use by the underwriter's sales force in its discussions with investors who may express interest in the offering during the confidential phase
- A preliminary prospectus supplement reflecting the offering terms that is ready to go on short notice once the issuer and the underwriter decide to flip the offering to a public offering

- Compliance with stock exchange listing requirements for public offerings
- Completion of due diligence on a very short time frame
- Compliance with Financial Industry Regulatory Authority, Inc. (FINRA) rules

Effective Shelf Registration Statement

An issuer considering a CMPO must have an effective registration statement on file with the SEC that will cover the securities to be sold. In addition, the issuer and underwriter must be cognizant of any limitations on the size of the proposed CMPO. In general, if the aggregate market value of the issuer's common stock held by non-affiliates is $75 million or more, the issuer can offer up to the maximum amount of securities available under its effective registration statement. However, if the aggregate market value of common stock held by non-affiliates is less than $75 million, the issuer can only offer up to one-third of that market value over a 12-month period. This one-third size limitation is typically referred to as the baby shelf rule. For further information on shelf registration statements, see Shelf Registration, Market Trends 2017/18: Shelf Registrations and Takedowns, Shelf Offerings, and Top 10 Practice Tips: Shelf Registration Statements and Takedowns.

Confidential Marketing and Wall-Crossing

In a typical CMPO, as described above, the underwriter approaches a discrete number of specific institutional investors who 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" (in other words, whether or not the potential investor is willing to receive confidential information about the issuer, to keep that information confidential, and to not trade in the issuer's securities for a certain period of time). Typically, the confidentiality agreement is solicited orally pursuant to a standardized script and then later confirmed in writing via email. For a form of script, see Investor Wall-Crossing Script and Email Confirmations. Some investors will agree to the confidentiality restrictions only if the issuer agrees to make a public disclosure of any material non-public information in the event the offering is abandoned, which is known as a cleansing disclosure. The cleansing disclosure would allow investors to resume regular trading in the issuer's securities.

If the potential investor agrees to the confidentiality requirements, then the underwriter will disclose information about the offering, including the identity of the issuer and the offering details. The marketing materials shared with potential investors during this confidential phase are typically limited to an issuer's filings under the Securities Exchange Act of 1934, as amended (e.g., Form 10-K and Form 10-Q), and the issuer's general investor presentations that are already in the public domain. By avoiding disclosure of non-public information or providing new written materials, the issuer can avoid the need to publicly file such information or materials or make any other cleansing disclosure if the offering is abandoned. After the marketing materials are shared, negotiations take place among the investors and the issuer and its underwriter regarding the offering (e.g., pricing discount, the terms of any warrants, and similar matters).

Flipping to a Public Offering

Once basic terms have been agreed to with the initial investors during the confidential phase, the issuer will announce the offering after market close and file its preliminary prospectus supplement. The underwriters will then commence the public offering phase of the CMPO to market the offering more broadly to other institutional investors and to retail investors. Marketing efforts may continue into the evening until the offering is priced. The final terms, including pricing and the terms of the warrants, if any, are announced the next day before the market opens. Following pricing, the securities settle and close like any traditional underwritten public offering on a T+2 basis. For more information, see Registered Securities Offerings Post-IPO.

Exchange Compliance Requirements

The listing rules for both the Nasdaq Stock Market (Nasdaq) and the New York Stock Exchange require shareholder approval for any offering, other than a public offering, where an issuer sells 20% or more of its outstanding common stock priced at a discount to market value (commonly referred to as the 20% rule). See 20% Rule and Other NYSE and NASDAQ Shareholder Approval Requirements. Because CMPOs are typically priced at a discount to market and often exceed the 20% size threshold, it is crucial that the CMPO be considered a public offering so as to avoid the requirement for shareholder approval.

Unfortunately, not every registered firm commitment underwritten offering will be deemed a public offering. Neither exchange has provided a bright-line definition of public offering but they have provided some useful guidance. Specifically, Nasdaq's staff will consider a number of factors, none of which are dispositive, including the following:

- The type of offering (firm commitment offerings are viewed more favorably than other offerings)
- Manner of the marketing of the offering, including the number of investors approached and the overall breadth of the marketing effort
- Extent of the distribution (e.g., the number and identity of the investors, any pre-existing relationships between the issuer and the investors, and the mix between institutional and retail)
- Offering price (i.e., the extent of the discount to market)
- Extent to which the issuer controls the offering and the distribution

The flip to a public offering as described above is intended to eliminate any concern as to whether the CMPO is a public offering for purposes of the 20% rule. Flipping to a public offering can also help fill out the book for the CMPO.

Due Diligence and Other Legal Considerations

Due diligence for a CMPO, even though somewhat hybrid in nature, is not materially different from a traditional underwritten public offering. The underwriter will generally conduct the same issuer diligence, including calls with the auditors and certain subject matter experts, and will still require legal opinions and comfort letters. The primary difference is the CMPO timetable. The often very short time from kick off to pricing (often just a few days) means the diligence obligations under the Securities Act of 1933, as amended, can be difficult to fulfill. For further information on due diligence, see Due Diligence for Securities Offerings Resource Kit, Due Diligence Considerations for a Follow-On Offering, and Top 10 Practice Tips: Due Diligence for Securities Offerings.

A CMPO will often require compliance with FINRA's corporate financing rule, Rule 5110, certainly for smaller cap issuers that are not eligible for any exemption therefrom. FINRA's same-day clearance process, which went into effect in 2010, has significantly streamlined the review process for registered offerings and likely contributed to the increased use of CMPOs in recent years. For further information, see FINRA Rule 5110 Requirements Checklist.

MARKET OUTLOOK

In light of recent market volatility, which can quickly turn a favorable capital-raising environment into an unfavorable one, and ongoing concerns about investor front-running (i.e., short selling prior to an offering), which can subject the issuer's stock price to significant downward pressure, CMPOs, together with other unannounced and accelerated offerings, should continue to represent the majority of follow-on offerings in 2018. CMPOs, combining private marketing, a quick flip into a traditional registered offering without any shareholder approval, and broad market acceptance, are here to stay and will likely expand their share of follow-on offerings as we move into 2019 and beyond.

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