



## Pre-funded Warrants

### What Are Pre-funded Warrants?

Pre-funded warrants are a type of warrant that allows the warrant holder to purchase a specified number of a company's securities at a nominal exercise price. The nominal exercise price may typically be as low as \$0.01 per share (often referred to as "penny warrants"). Unlike standard warrants, "pre-funded" warrants allow the company to receive the exercise price (that would have otherwise been due at the time of exercise of the warrant) as part of the purchase price upon the issuance of the warrant.

Generally, the holder of a pre-funded warrant may, at its option, exercise the warrant, in whole or in part, immediately following the issuance of the warrant and for the duration of the exercise period, which may be up to ten years in some cases. However, as with other types of warrants, the value of a pre-funded warrant tends to decrease over time as expiration approaches. Further, a pre-funded warrant that expires without having been exercised has no further value and the purchase price of the pre-funded warrant paid by the holder at the time of issuance is not returned to the holder at expiration. The unique risks associated with pre-funded warrants compared to traditional warrants should be adequately disclosed to investors in the related offering document.

Pre-funded warrants are typically issued as a "sweetener" in connection with a larger capital raise, such as a venture capital investment, minority equity investment, or mezzanine financing. The issuance of the pre-funded warrant may allow the issuer to obtain better terms with respect to the other concurrently issued financing instruments (e.g., common stock) without having to issue additional debt or preferred securities. As part of, or concurrent with, an investment in pre-funded warrants, investors will generally also invest in the warrant issuer's other classes of securities. For small-cap and mid-cap companies, a private placement or a PIPE transaction might consist of the offer and sale of shares of common stock and pre-funded warrants.

### Advantages Associated With Pre-Funded Warrants

Pre-funded warrants allow investors who are otherwise restricted from owning a company's voting securities above a certain threshold (usually, 9.99% or 19.99%) to invest in the company without violating the applicable ownership restrictions. Similar to other warrants, pre-funded warrants allow the holder to avoid owning the underlying securities prior to the exercise of the warrant and, in turn, violating any ownership restrictions while being able to acquire the underlying securities at a nominal exercise price when the holder is ready and permitted to do so. Pre-funded warrants are also beneficial to issuers in that they allow the issuer to receive almost all of the cash proceeds immediately upon issuance of the warrant, which may coincide with a time when the company's underlying valuation is difficult to determine, as opposed to waiting until the warrant is exercised at a later date. Additionally, including the option to offer pre-funded warrants in a transaction potentially expands the pool of prospective investors by resolving certain ownership concerns in certain circumstances.

The feature of pre-funded warrants that allows holders to delay ownership of a company's common stock is particularly important to holders who already hold, or plan to acquire, a large stake in a company. This is because an investor with a significant ownership interest in a company will likely be deemed an affiliate of the company. Moreover, in the absence of other large investors, a significant minority stake in a company could cause an investor to be considered a controlling shareholder, thereby imposing upon it fiduciary duties to the company's other shareholders. The determination of whether a holder of a company's equity securities is an affiliate of the company is a fact-specific analysis, but investors who directly or indirectly hold more than 10% of an issuer's equity or are otherwise in a control relationship with the company (including rights relating to the appointment of directors) may frequently be considered to be "affiliates" of the company.

The federal securities laws impose numerous restrictions and limitations on affiliates and affiliate transactions, thus providing an incentive for investors to avoid affiliate status. In particular, Rule 144 under the Securities Act of 1933, as amended, provides a safe harbor for public resales of a company's securities without having to register the resale with the Securities and Exchange Commission. Rule 144 contains five basic requirements in order to benefit from the safe harbor, although not all requirements apply to every resale. Affiliates of a company must comply with all five requirements, which can sometimes be quite burdensome and even impracticable. However, investors who are not affiliates at the time of the sale, and have not been affiliates for the three months preceding the sale, must only comply with Rule 144's holding period and current public information requirements.

Given these concerns regarding affiliate status, certain investors have imposed ownership restrictions that must be addressed prior to a capital investment. Pre-funded warrants can be a helpful supplement to an existing or proposed capital investment in order to immediately provide the needed capital to the company while at the same time taking into consideration the investor's ownership concerns.

### **Structuring Considerations**

Warrants are traditionally exercised by the holder providing an executed notice to the issuer and paying the specified exercise price. Pre-funded warrants are structured to include a nominal exercise price. The purchase price that is paid at the time the pre-funded warrant is obtained by the holder (along with any other securities that are packaged together with the pre-funded warrant) takes into consideration the fact that the pre-funded warrant will have a nominal exercise price. As a result, the pre-funded warrant's purchase price is expected to be significantly higher than a traditional warrant's purchase price providing the issuer with the net proceeds upfront. The pre-funded warrant may alternatively be structured to allow the holder to elect net share exercise, in which case the holder would receive the net number of shares of common stock determined according to the specified formula. Similar to a traditional warrant's structure, the holder of a pre-funded warrant will not have the voting rights attributable to a holder of the issuer's common stock until the holder exercises the warrant.

Anti-dilution protective provisions must be carefully considered in the context of pre-funded warrants given the inability to adjust the pre-funded warrant's nominal exercise price (as a result, "full ratchet" and "weighted average" anti-dilution provisions may not be used). Instead, pre-funded warrants must be structured to proportionally adjust the number of shares underlying the warrant following a specified change to the company's capitalization. Stock splits, including reverse stock splits, mergers, acquisitions, or similar recapitalizations or reorganizations of the issuer are often included as anti-dilution triggering events. Other anti-dilution provisions may be included to protect holders from a future issuance of equity, convertible securities or additional pre-funded warrants. The pre-funded warrant may also be structured with anti-dilution protection in the event of any significant distribution or dividend of the issuer's assets. These anti-dilution provisions will adjust the number of shares issuable by the pre-funded warrant (with the nominal exercise price remaining unchanged) in the event that the issuer issues equity, convertible securities or additional pre-funded warrants at a price below the fair market value of the issuer's common stock.

Pre-funded warrants are also often structured to include a provision that is triggered by a merger, acquisition, or similar reorganization (i.e., a fundamental transaction) and that entitles the holders to receive the kind and amount of securities, cash or other property that the holders would have received had they exercised the pre-funded warrants immediately prior to the occurrence of such fundamental transaction.

### **"20% Rule" Considerations**

Subject to certain exemptions, both the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market ("Nasdaq") require shareholder approval in connection with a discounted private offering of common stock or securities convertible into or exercisable for common stock (such as pre-funded warrants) if the number of shares or the voting power of the common stock subject to the offering is equal to or greater than 20% of the pre-transaction shares or voting power outstanding before the issuance. This is typically referred to as the "20% Rule."

The 20% Rule is intended to provide a company's shareholders with advance notice of a proposed private offering, thereby allowing a company's shareholders to sell their shares or vote on the proposed offering due to the potential for dilution. An offering of pre-funded warrants that are exercisable for 20% or more of a company's common stock has the potential to be dilutive to existing shareholders. Indeed, since pre-funded warrants are typically issued to meet and address the specific ownership concerns of the company's larger investors, existing shareholders typically do not participate in a pre-funded warrant offering and, accordingly, the potential for dilution may be greater.

Nasdaq has indicated that it closely examines any offering that includes warrants that are exercisable for little or no consideration. Nasdaq may exercise its discretionary authority to object to a transaction involving warrants with a nominal exercise price, even when the 20% rule does not apply. Issuers considering a transaction involving pre-funded warrants or other deeply discounted securities should consult Nasdaq before moving forward. The NYSE does not provide guidance on the evaluation of pre-funded warrants, however, NYSE is willing to discuss the interpretations of its shareholder approval rules.

Pre-funded warrants that are included with common stock as part of a concurrent common stock or unit offering will also impact the total market value analysis for purposes of the 20% Rule if the total purchase price is below the greater of the company's market or book value under the NYSE rules. However, following recent amendments to Nasdaq's 20% rule, shareholder approval is only



“required prior to a 20% Issuance at a price that is less than the Minimum Price.” The amended Nasdaq rule defines “Minimum Price” as “the price that is the lower of (1) the closing price (as reflected on Nasdaq.com) or (2) the average closing price of the common stock (as reflected on Nasdaq.com) for the five trading days immediately preceding the signing of the binding agreement.” In addition, the amended Nasdaq rules do not require shareholder approval where the issuance price is less than book value but greater than market value. Accordingly, under the new Nasdaq rules, if the common stock portion of an issuance that includes pre-funded warrants is greater than the 20% threshold and the shares and pre-funded warrants are priced below book value but above market value, the transaction would not require shareholder approval. The NYSE has filed for a rule change that would align its rules with the amended Nasdaq rule.

### Sample Pre-funded Warrant Clauses

For reference, set forth below is sample language typically included in a pre-funded warrant:

**Mechanics of Exercise.** Subject to the terms and conditions hereof, this Warrant may be exercised by the Holder on any day on or after the Issuance Date (an “Exercise Date”), in whole or in part, by delivery (whether via facsimile or otherwise) of a written notice (the “Exercise Notice”) of the Holder’s election to exercise this Warrant. Within one (1) Trading Day following an exercise of this Warrant as aforesaid, the Holder shall deliver payment to the Company of an amount equal to the Exercise Price (as defined below) in effect on the date of such exercise multiplied by the number of Warrant Shares as to which this Warrant was so exercised (the “Aggregate Exercise Price”) in cash or via wire transfer of immediately available funds if the Holder did not notify the Company in such Exercise Notice that such exercise was made pursuant to a Cashless Exercise (as defined below). The Holder shall not be required to deliver the original of this Warrant in order to effect an exercise hereunder. Execution and delivery of an Exercise Notice with respect to less than all of the Warrant Shares shall have the same effect as cancellation of the original of this Warrant and issuance of a new Warrant evidencing the right to purchase the remaining number of Warrant Shares. Execution and delivery of an Exercise Notice for all of the then-remaining Warrant Shares shall have the same effect as cancellation of the original of this Warrant after delivery of the Warrant Shares in accordance with the terms hereof.

**Exercise Price.** For purposes of this Warrant, “Exercise Price” means \$0.01 per Warrant Share, subject to adjustment as provided herein.

**Cashless Exercise.** If at the time of exercise hereof there is no effective registration statement registering, or the prospectus contained therein is not available for the issuance of the Warrant Shares to the Holder, then this Warrant may also be exercised, in whole or in part, at such time by means of a “cashless exercise” in which the Holder shall be entitled to receive a number of Warrant Shares equal to the quotient obtained by dividing [(A-B) (X)] by (A), where:

(A) = as applicable: (i) the VWAP on the Trading Day immediately preceding the date of the applicable Notice of Exercise if such Notice of Exercise is (1) both executed and delivered pursuant to [Section 2(a)] hereof on a day that is not a Trading Day or (2) both executed and delivered pursuant to [Section 2(a)] hereof on a Trading Day prior to the opening of “regular trading hours” (as defined in Rule 600(b)(64) of Regulation NMS promulgated under the federal securities laws) on such Trading Day, (ii) at the option of the Holder, either (y) the VWAP on the Trading Day immediately preceding the date of the applicable Notice of Exercise or (z) the Bid Price of the Common Stock on the principal Trading Market as reported by Bloomberg L.P. as of the time of the Holder’s execution of the applicable Notice of Exercise if such Notice of Exercise is executed during “regular trading hours” on a Trading Day and is delivered within two (2) hours thereafter pursuant to Section 2(a) hereof or (iii) the VWAP on the date of the applicable Notice of Exercise if the date of such Notice of Exercise is a Trading Day and such Notice of Exercise is both executed and delivered pursuant to Section 2(a) hereof after the close of “regular trading hours” on such Trading Day;

(B) = the Exercise Price of this Warrant, as adjusted hereunder; and

(X) = the number of Warrant Shares that would be issuable upon exercise of this Warrant in accordance with the terms of this Warrant if such exercise were by means of a cash exercise rather than a cashless exercise.

If Warrant Shares are issued in such a cashless exercise, the parties acknowledge and agree that in accordance with Section 3(a)(9) of the Securities Act, the Warrant Shares shall take on the registered characteristics of the Warrants being exercised. The Company agrees not to take any position contrary to this Section. Notwithstanding anything herein to the contrary, on the Termination Date, this Warrant shall be automatically exercised via cashless exercise pursuant to this Section.



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**On point.**

