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PIPEs and registered directs: back to the future

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PIPE and registered direct transactions have become important hybrid financing alternatives for companies that need to raise capital in difficult market environments or that need to raise capital quickly, or both. Investments in PIPEs tripled from 2004 to 2005. In 2005, more than $20bn was invested in PIPEs. For the first six months of 2006, over $24bn has been raised in PIPEs. Registered direct investments during the same period have grown at record levels. This is, no doubt, why we are asked the same three questions several times each week: what are PIPES and registered directs? How do they actually work? What should we be thinking about as we proceed to execute a PIPE or registered direct? The following discussion is a response to these questions.

The acronym 'PIPE' refers to a private investment in public equity. Several capital-raising techniques involving some element of a private financing by an already-public company have been referred to as PIPEs. Most of these techniques have nothing to do with PIPEs. PIPEs are a specific form of private placement to 'accredited investors' that irrevocably commit to purchase securities (usually common or preferred stock) at a fixed price, not subject to market price adjustments or fluctuating ratios. In this regard, PIPEs may be distinguished from 'future-priced' or 'death spiral' financings and equity lines, which have become financings of last resort for small public companies.

So, how do they work? PIPE investors contract to purchase an issuer's securities in a private placement and receive restricted securities. The issuer undertakes to file with the Securities and Exchange Commission, or SEC, a registration statement covering the resale from time to time by the investors of those restricted securities. The timing of registration is negotiated between the issuer and investors. The issuer may commit to file and have declared effective a resale registration statement immediately prior to, or promptly following, the closing of the private placement. The issuer frequently may use a short-form (Form S-3) registration statement to register the resale of the securities, even if the issuer would not be eligible to use that form for its primary offerings. The resale registration statement is kept effective until investors may sell the securities pursuant to Rule 144(k).

The advantages of a PIPE over a conventional private placement are numerous: issuers are not burdened with significant post-closing requirements, like stringent operating covenants; issuers may finance quickly without incurring substantial transaction costs; and their securities may be sold at a smaller discount to market because issuers commit to have a resale registration statement available for investors. Disclosure of the transaction occurs only after the issuer receives definitive purchase commitments, thus reducing the market impact of the financing. Investors bear price risk once they execute the purchase agreement, but they obtain relative certainty of prompt liquidity. Foreign investors may participate in PIPEs provided the offering to them is made in compliance with applicable jurisdictional regulations. In fact, it was European institutional investors who joined with us to create the PIPE methodology in 1985. Most European jurisdictions now have a form of 'private placement exemption' that may be satisfied easily in connection with PIPEs. A PIPE also may be used to sell stock held by an issuer's existing security holders.

Registered direct transactions, or agency (best efforts) SEC-registered public offerings are marketed principally to institutional investors and share many elements in common with PIPEs. An issuer with a shelf registration statement may conduct a registered direct quickly and without incurring significant transaction costs. A registered direct also may be completed using a single-purpose, or bullet, registration statement if the issuer does not have, or is ineligible to use, a shelf registration statement. Registered directs typically are marketed and sold like private placements, with only a small number of potential investors being contacted by the placement agent. Targeted marketing permits testing the waters without committing publicly to a transaction. A placement agent retained by an issuer with an already effective registration statement may engage in a non-deal road show, or simply assess market appetite for a financing, without a prospectus supplement. Even if the placement agent and issuer decide that it is prudent or necessary to use a preliminary prospectus supplement, the filing describing the transaction usually will not subject the issuer's stock to the barrage of short-selling often associated with filing of an underwritten follow-on offering. The registered direct possesses the targeted marketing appeal and cost and time efficiencies associated with private placements, while having the benefits of a 'registered' deal. Investors receive registered stock. Placement agents may allocate securities to retail investors, as well as to mutual funds and pension funds that have limitations on their private securities holdings. Because there is no 'liquidity' concern with registered directs compared to PIPEs, issuers obtain better pricing for their securities. Given the prevalence of shelf registration statements and the ease, post-securities offering reforms, of filing shelf registration statements, especially for well-known seasoned issuers, registered directs are popular.

Hedge funds, PIPEs and the SEC

In recent years, PIPEs, registered directs and other hybrid financings have received attention in the press, stemming from the problematic trading practices of certain PIPE buyers. In 1985, when we first created PIPEs, the most active PIPE investors ▸▸

were institutional or ‘sector’ investors that wished to make a long-term investment in a particular company or sector. Market dynamics changed as the number of hedge funds multiplied and as they have become an increasingly significant force in the financial markets. Hedge funds participate actively in hybrid financings. Some hedge funds purchasing in these transactions are ‘financial buyers’ that view the transactions simply as part of an arbitrage strategy, and, consequently, pay less attention to the fundamentals of the issuer. Their trading in proximity to PIPEs caught the SEC’s attention in connection with its hedge fund regulation and enforcement initiative. After analysing their trading, the SEC brought enforcement actions against hedge fund principals active in PIPEs for insider trading violations and market manipulation. These funds traded in advance of news of a PIPE being made public or in possession of other material non-public information. Other funds engaged in manipulative trading practices, usually short selling, in connection with PIPEs – selling short the securities of the PIPE issuer in anticipation of a PIPE being completed. Recently implemented restrictions on short selling also may limit some of the most abusive trading practices involving PIPEs.

These regulatory actions also underscore to issuers and financial intermediaries the important considerations to bear in mind when conducting unannounced financings.

Silence is golden

Issuers, placement agents and potential investors in unannounced financings, like PIPEs and registered directs, must focus on disclosure issues during marketing. An issuer contemplating a PIPE or registered direct will not have disclosed publicly the potential financing. In fact, the ‘stealth’ nature of a hybrid financing is one of its appealing aspects. In order not to compel a premature disclosure by the issuer, the placement agent must implement compliance procedures designed to ensure that potential investors are aware of the confidential nature of these financing discussions. Potential investors generally do not receive any material non-public information regarding the issuer or its business, with marketing materials usually limited to an issuer’s Exchange Act or other public filings; however, the fact that the issuer is considering a financing may itself constitute material non-public information.

Placement agents often enter into either transaction-specific confidentiality agreements or ‘omnibus’ confidentiality agreements. These agreements require potential investors to acknowledge they will receive information about a transaction that will not be publicly disclosed and that they know how to handle such non-public information under US securities laws. Other placement agents rely on scripts to pre-qualify potential investors and receive oral undertakings, subsequently confirmed in writing.

On their part, institutional investors that are frequent participants in these transactions may set up trading walls within their organisations to limit information flow regarding PIPEs and registered directs and implement appropriate trading restrictions. For most transactions where the marketing period is abbreviated and the number of investors contacted is small, limiting the flow of information should not be difficult. In more challenging deals, as the sales cycle is elongated, both the issuer and the placement agent should monitor carefully trading in the issuer’s stock for unusual price or volume changes. Placement agents also must remain attentive to their know-your-customer obligations, which will compel them to allocate securities to buy-and-hold investors. Placement agents should carefully consider their internal compliance procedures, including the use of ‘watch’ or restricted lists, research limitations, and their sales and marketing procedures for hybrid financings, including the training and supervision of those within their organisations responsible for marketing these transactions.

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20 percent solution

The securities exchange on which an issuer’s common stock is quoted may require that an issuer obtain prior stockholder approval for certain private placements or PIPEs. Although a registered direct transaction is by definition a ‘public offering’ for SEC purposes, in certain instances, depending on the facts and circumstances, a registered direct may be considered by securities exchanges to be a ‘private placement’ since it is not a firm commitment underwriting and it is marketed to a limited number of investors.

Prior stockholder approval generally will be required for a private placement completed at a discount to the then market price of the stock if the offering may result in the issuance of 20 percent or more of the issuer’s outstanding capital stock or will increase by 20 percent or more the voting power outstanding prior to issuance. An issuer should consider not only the effect of completing a proposed transaction, but also, if it has completed other private transactions within the same six-month period, the aggregate effect of these, all of which may be integrated. Exchange rules presume that several private financings completed within a six-month period should be integrated and considered part of a continuing offering for these approval requirements. Each of the New York Stock Exchange, the American ▸▸

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Stock Exchange and Nasdaq has similar requirements. Stockholder approval also may be required for an issuance that may exceed 20 percent of the common stock or 20 percent or more of the voting power outstanding before the issuance if the issuance is related to an acquisition, or if the issuance will result in a change of control.

Determining whether a proposed transaction requires stockholder approval often is difficult. A placement agent may structure a transaction as an 'at market' sale of common stock with warrants exercisable for common stock. If the warrant exercise price is above the market price of the common stock on the closing date and the warrants are not exercisable for a six-month period, the transaction may not require stockholder approval. For accounting or other reasons, the issuer may not wish to offer warrants, and, instead, may wish to offer convertible securities. The exchanges require that an issuer obtain stockholder approval if an issuance of convertible securities may result in the issuance of stock equalling 20 percent or more of the outstanding stock. A transaction may also be structured in tranches, with a first tranche falling under the 20 percent threshold and with a stockholder vote scheduled to occur after the first tranche closing.

There is little interpretative guidance regarding the application of these regulations; consequently, transactions must be reviewed with the exchanges. The exchanges have begun scrutinising hybrid financings more closely and imposing more stringent stockholder approval requirements. For example, many structures that involved conditional issuances subject to receipt of stockholder approval or that involved interest or dividend rate step-ups for convertible securities conditioned on the failure to receive stockholder approval, now are viewed by the exchanges as coercive and impermissible. Similarly, the exchanges are scrutinising transactions that include caps on the number of shares that can be issued or a floor on the conversion price of a convertible security as a means of avoiding the need for upfront stockholder approval.

Whither go the warrants? And the converts?

Companies considering PIPEs also should consider the accounting challenge posed by EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock". This standard issued by the Emerging Issues Task Force of the Financial Accounting Standards Board has existed for approximately six years; however, in December 2005, the SEC published accounting policy guidance on its application to offerings of warrants and convertible securities. Issuers must now analyse warrants to determine whether they should be accounted for as a liability or an equity instrument. The embedded conversion feature in convertible debt and preferred securities should be analysed to determine whether the conversion feature should be bifurcated pursuant to SFAS 133 and whether the conversion feature should be accounted for as a liability or equity. If there are registration rights associated with shares underlying warrants or convertible instruments and the issuer is required to pay liquidated damages for failure to register the underlying shares within the required time period or for failure to keep effective a resale registration statement relating to the shares, EITF 00-19 is likely to require accounting for the securities as a liability.

In PIPEs, an issuer typically agrees to file a resale registration statement within a certain time period following completion of the financing, to use its best efforts to obtain effectiveness of the resale registration statement within a certain time period (usually 60 or 90 days) following filing, and to maintain the effectiveness of the registration statement for two years. During this two-year period, the issuer may suspend the use of the registration statement to correct material misstatements or omissions. This suspension period is known as a 'black-out period'. During the black-out period, investors will have limited liquidity as they will not be able to avail themselves of the resale registration statement. Financial penalties usually are associated with an issuer's failure to meet the filing deadline or the effectiveness deadline or with exceeding the black-out limitation.

In order to address possible EITF 00-19 issues, the parties should consider implementing caps or limits on the number of shares to be delivered upon exercise of a conversion feature or an anti-dilution feature, as well as caps on these liquidated damages provisions. Structurers also should consider implementing cash-only settlement features and eliminating or circumscribing 'net share' settlement features for convertible securities.

There is still some ambiguity concerning the application of EITF 00-19 to warrants and convertible securities; however, several issuers that completed financings involving warrants or convertible securities have been required to restate their financial statements in order to give effect to these accounting principles.

Back to the future

So, in light of the preceding discussion of regulatory, structuring and accounting considerations, what should one be thinking about when considering a PIPE or registered direct? We may not be able to answer that question for everyone, but at least we can comment on what we are thinking about. We think the PIPE and registered direct markets will once again be led by sector investors and that the role of arbitrage buyers will decline. We believe this will result in more large hybrid financing transactions for larger companies. And, finally, we think there will be a shift toward more common stock deals. Sector buyers tend to have a buy-and-hold approach and usually do not seek the downside protection or arbitrage opportunity presented by warrants and convertible securities. If our predictions turn out to be correct, PIPEs and registered direct will make the journey back to the future. ■

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