

# REGULATORY RISKS BECOME OPPORTUNITIES FOR PIPES INVESTORS

By James G. Smith



The Securities and Exchange Commission's shift in interpretation of Rule 415 under the Securities Act of 1933 fundamentally altered the micro cap "PIPE" market. Without reciting its entire history, Rule 415 allows a publicly traded issuer to sell shares on a delayed or continuous basis in the future if the issuer

or the type of offering meets one of several criteria. One of those criteria, which PIPES investors have traditionally relied, is the registered offering for resale by selling shareholders. The number of securities, presumably common stock, being registered for resale by the issuer can be significantly large and, if too large, under the staff's interpretation, will cause the PIPES investor to become an underwriter and not a selling shareholder. The staff informally defines "too large" at about 30% of the issuer's outstanding shares. Absent the issuer or the transaction falling within one of the other Rule 415 criteria, the resale by the PIPES investor into the market must be at a fixed price.

As a result of this shift in interpretation, PIPES investors and the issuers that rely on PIPES financing have assumed that PIPES transactions, at least in the smallcap and microcap markets, are essentially dead. News of such demise is greatly exaggerated.

Where opportunities in the traditional PIPES market have been stalled by regulatory hurdles, new opportunities for PIPES investors, particularly those PIPES investors which tend to focus on a long term strategy, have been created. These PIPES investors are taking long term strategies – from one to two or more years before a liquidation event. These strategies are shorter than traditional venture capital investors' strategies,

typically five to seven years, but longer than many PIPES short term investors, seeking to start liquidating within three to six months.

What makes this opportunity attractive? Valuation. By taking a long term strategy, these PIPES investors are looking to command a greater discount to the issuer's market price. But the long term strategy also has its share of concerns that PIPES investors should consider.

## STRENGTHEN COVENANTS

Heavily negotiated provisions in a PIPES deal frequently surround the registration rights agreement, which usually include various liquidated damages upon the issuer's failure to file, and get effective, a resale registration statement within a certain period of time. Long term investors should focus on other protections to make sure investments are reasonably protected, such as:

- forfeit mandatory and demand registration rights, but protect piggyback registration rights
- consider restrictive covenants—both negative covenants (what the issuer may not do without the investor's consent) and positive covenants (what the issuer must do without the investor's waiver)
- secure convertible debt with liens on the issuer's assets

## PROTECT RIGHTS UPON OTHER LIQUIDITY EVENTS

Short-term PIPES investors have traditionally looked at selling in the public markets as the liquidity event. Long

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term investors need to protect their resale rights into the public markets, but must also look to other liquidity events, such as:

- a merger of the issuer
- a sale of the issuer's assets
- redemption of the securities by the issuer
- management buyout
- sales to a strategic third party

Each liquidity event poses its own problems, and opportunities, to a PIPES investor. Longer liquidity horizons add risk that events will shift the direction of the issuer, and shift the ability, and profitability, of the PIPES investor's liquidity event. Negotiating protective provisions in the purchase agreement will reduce these risks.

### PROTECT RULE 144 RESALE RIGHTS

Where registration rights were the focus of the traditional PIPES investor, protecting rights to resell under Rule 144 is much more important to the long-term PIPES investor. Generally, a shareholder may resell securities of an issuer

that is reporting under the Securities Exchange Act of 1934 provided the shareholder has held for at least one year. Resales of securities of OTCBB-traded companies are limited to 1% of such outstanding securities every three months. If the shareholder has held the securities for at least two years, then there is no 1% limit. PIPES investors should carefully consider protecting resale rights, such as negotiating in the purchase agreement the issuer's irrevocable consent allowing its transfer agent to accept the investor's counsel's Rule 144 legal opinion.

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