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SEC Eases Form S-3/F-3 Eligibility

The Securities and Exchange Commission ("SEC") on December 19, 2007 amended the eligibility requirements for the use of Form S-3 (and Form F-3 for foreign private issuers), effective January 28, 2008, as part of its initiatives to increase access to the capital markets by smaller public companies. The primary purpose of the amended eligibility rules is to permit smaller business issuers, *i.e.,* issuers with a non-affiliate public float of less than $75 million, to benefit from the greater flexibility and efficiency in accessing the public securities markets afforded by Form S-3, without compromising investor protection.

Amendments to the Eligibility Requirements of Form S-3

Form S-3 is the "short form" registration statement used by companies to register and conduct primary offerings "off the shelf" under Rule 415 of the Securities Act of 1933, as amended (the "Securities Act"), which confers significant advantages over other forms of registration. For example, Form S-3 permits the registration of securities offerings prior to planning any specific offering and, once the registration statement is effective, companies utilizing Form S-3 may offer securities in one or more tranches without waiting for further SEC action. Further, Form S-3 is an "evergreen" form of registration statement – that is, it permits an issuer to incorporate by reference its reports filed with the SEC subsequent to the filing of the Form S-3. Without this ability, registrants must file a new registration statement or a post-effective amendment to its registration statement to prevent information in its registration statement from becoming outdated and to update the disclosures for material changes.

Despite the adoption of amendments easing the eligibility to utilize Form S-3, there remain certain limitations imposed on issuers, including the following:

- An issuer must meet the other registrant eligibility conditions for use of Form S-3, which are as follows:
  - The issuer must be organized under the laws of a jurisdiction in the United States, and must have its principal place of business located in the United States;
  - The issuer must have been public for at least 12 calendar months; and
  - The issuer must have timely filed all of its required reports under the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), during the last 12 months preceding the filing of the registration statement (and during the portion of the calendar month immediately preceding the filing of the registration statement), subject to certain limited exceptions.
- An issuer with a public float under $75 million may not sell more than 33.33% (one-third) of its public float in primary offerings over any period of 12 calendar months per General Instruction I.B.6. to Form S-3. To ascertain the amount of securities that may be sold pursuant to Form S-3 by registrants with a public float under $75 million, the new rule requires a two-step process:
  - *Determine the public float immediately prior to the intended sale*. Public float is calculated by multiplying the price at which the issuer's common equity was last sold, or the average of the bid and asked prices of its common equity, in the principal market for the common equity, as of a date within 60 days prior to the date of sale, by the number of shares of common equity outstanding held by non-affiliates of the issuer. If an issuer had common equity outstanding held by non-affiliates of the issuer, but not trading in a public trading market, it would not be permitted to use Form S-3 for primary offerings; and

- *Aggregate all sales of securities*, including equity and debt, pursuant to primary offerings in the previous 12-month period on Form S-3 (including the intended sale) to determine whether the one-third limitation would be exceeded. To calculate the aggregate market value of securities sold during the preceding 12-month period, an issuer would add together the gross sales price for all primary offerings pursuant to proposed General Instruction I.B.6 to Form S-3 during the preceding 12-month period.

- Registrants must have a class of common equity securities listed on a national securities exchange[1] and registered pursuant to Section 12(b) or 12(g) of the Exchange Act or be required to file reports pursuant to Section 15(d) of the Exchange Act; and have been subject to the filing requirements of Sections 12 or 15(d). Accordingly, an issuer may not be either an OTC.BB or Pink Sheet company.

- An issuer may not be a shell company or have been a shell company for at least 12 calendar months prior to the filing of the registration statement.

Importantly, in its final rules release, the SEC made clear that if an issuer is temporarily prevented – due to the one-third cap – from using Form S-3 to raise capital, such issuer would not be foreclosed from registering a primary offering on Form S-1 or selling in private placements. Therefore, the new eligibility instruction adopted by the SEC was not meant to be exclusive. Rather, it was designed to provide added flexibility to smaller public companies by giving them supplemental avenues for capital formation.

Note, however, that the SEC also made clear that violations of the one-third primary offering restriction will also violate the requirement as to proper registration form, even though the registration statement had previously been declared effective.

Amendments to the Eligibility Requirements of Form F-3

The changes to the eligibility requirements for Form F-3 mirror those for Form S-3. As such, foreign private issuers wishing to use Form F-3 and lacking the $75 million in public float must:

- Meet the other registrant eligibility conditions for the use of Form F-3;

- Not be a shell company or have been a shell company for at least 12 calendar months before filing the registration statement; and

- Not sell more than the equivalent of one-third of their public float in primary offerings under General Instruction I.B.5. to Form F-3 over any period of 12 calendar months.

Reasoning Behind the Amendments

The issue of Form S-3 eligibility for primary offerings was addressed by the SEC's Advisory Committee on Smaller Public Companies (the "Advisory Committee"), which the SEC chartered in 2005 to assess the current regulatory system for public companies under U.S. securities laws. In its "Final Report," dated April 23, 2006, the Advisory Committee noted that smaller public companies faced particular challenges relating to capital formation and were especially hard-hit by the costs of compliance with Section 404 of the Sarbanes-Oxley Act of 2002 ("Section 404"). To ease this burden on smaller public companies, the amendments to the Form S-3 eligibility rules were adopted. In support of its reasoning, the Advisory Committee relied, in-part, on the 2005 Federal Government's Office of Advocacy study by W. Mark Crain, *The Impact of Regulatory Costs on Small Firms*, which found that, in general, small businesses are excessively negatively affected by federal regulations.[2] Crain found that small firms with fewer than 20 employees annually spend forty-five percent (45%) more per employee than larger firms to comply with federal regulations. Likewise, the report by the Advisory Committee noted that Section 404 costs in relation to revenue are disproportionately borne by smaller public companies.[3] The report also found that small public companies with a market capitalization of under $100 million are expected to spend approximately 2.55 percent of their revenue on Section 404 compliance, while larger companies with a market capitalization of over $1 billion are expected to spend 0.16 percent of their revenue on such costs.[4] Further, the November 2006 studies by the Committee on Capital Markets

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[1] A "national securities exchange" is a securities exchange that has registered with the SEC under Section 6 of the Exchange Act (15 U.S.C. 78f). There are currently ten securities exchanges registered under Section 6(a) of the Exchange Act as national securities exchanges. These are the New York Stock Exchange, American Stock Exchange and Nasdaq, as well as the Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, International Securities Exchange, National Stock Exchange (formerly the Cincinnati Stock Exchange), NYSE Arca (formerly the Pacific Exchange) and the Philadelphia Stock Exchange.

[2] The Impact of Federal Regulations on Small Firms, an Advocacy-funded study by W. Mark Crain, Sept. 2005 available at: http://www.sba.gov/advo/research/rs264tot.pdf.

[3] SEC Advisory Committee Report, at 33.

[4] *Id.*

Regulation[5] and the U.S. Chamber of Commerce[6] substantiate the belief that Section 404's constraints have made the United States' capital markets an increasingly unattractive environment to list shares, reducing the number of initial public offerings, and forcing companies to go private or to be listed on non-U.S. securities exchanges.

As a result of its findings, the Advisory Committee recommended that the SEC allow smaller public companies with securities listed on a national securities exchange to be eligible to utilize Form S-3/F-3. Accordingly, the SEC adopted the amendments discussed above.

Effect on Registered Direct Offerings

The amended Form S-3/F-3 eligibility rules provide many smaller public companies increased flexibility to conduct limited public offerings of securities at times and under conditions that are best suited for them, with fewer regulatory requirements, while maintaining sufficient investor protection. The amended rules are likely to have the following effect on registered direct offerings: (i) provide additional flexibility to smaller business issuers so they can sell registered securities under an effective shelf registration under Rule 415 when market conditions permit; and (ii) make it easier for smaller business issuers to raise money in a Registered Direct offering.

Fluctuating Public Float

While there still exists a limit on the dollar amount equal to or less than one-third of the issuer's public float, the amount of securities that an issuer is permitted to sell may increase over time as the issuer's public float increases. Therefore, the value of one-third of a registrant's float during the period that a registration statement is effective may, at any given time, be much greater than at the time the registration statement was initially filed. An issuer may, therefore, benefit from increases in the size of its public float during the effectiveness period. Conversely, a decrease in an issuer's public float will decrease the amount of securities that such issuer may sell.

It is important to note, however, that a contraction in an issuer's public float such that the value of one-third of the public float decreases from the time such registration statement was initially filed, would not necessarily run afoul of the one-third cap, because the relevant point in time for considering whether an issuer has exceeded the threshold is at the time of sale of such securities. If the sale of the securities, together with all securities sold in the preceding period of 12 calendar months, does not exceed one-third of an issuer's float calculated within 60 days of the sale, then the transaction would not violate the new General Instruction I.B.6., even if an issuer's public float later drops to a level such that the prior sale now accounts for more than one-third of the new lower float.

Form S-3 registrants who meet the $75 million public float threshold of existing General Instruction I.B.1. at the time their registration statement is filed are not subject to restrictions on the amount of securities they may sell under the registration statement, even if their float falls below $75 million subsequent to the effective date of the Form S-3, but prior to the update required under Section 10(a)(3) of the Securities Act. The SEC believed it was appropriate to provide issuers registering on Form S-3 pursuant to new General Instruction I.B.6. the same flexibility if their float increases to a level that equals or exceeds $75 million subsequent to the effective date of their Form S-3 without the additional burden of filing a new Form S-3 registration statement. Of course, pursuant to Rule 401 under the Securities Act, issuers are also required to recompute their public float each time an amendment to the Form S-3 is deemed filed for the purpose of updating the registration statement in accordance with Section 10(a)(3) of the Securities Act – typically when an issuer files its annual report on Form 10-K is filed. In the event that an issuer's public float as of the date of the filing of the annual report is less than $75 million, the one-third cap will be reimposed for all subsequent sales made pursuant to new General Instruction I.B.6. and will remain in place until the issuer's public float equals or exceeds $75 million.

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[5] Committee on Capital Markets Regulation, Interim Report of the Committee on Capital Markets Regulation (Nov. 30, 2006), available at: http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

[6] Commission on the Regulation of U.S. Capital Markets in the 21st Century, Report and Recommendations (March 2007), available at: http://www.uschamber.com/portal/capmarkets/default.

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