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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Inside Nasdaq's Proposed Shareholder Approval Rules

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Kristopher D. Brown

Thomas J. Friedmann

David S. Rosenthal

Nasdaq Inc. announced that it is soliciting public comments on whether and how to update shareholder approval rules for companies listed on the Nasdaq Stock Market on Nov. 18, 2015. Nasdaq is accepting comments through Feb. 15, 2016.

The current Nasdaq Stock Market rules requiring shareholder approval were adopted in 1990 and Nasdaq believes that modifications are now necessary as times have changed with respect to corporate governance; specifically, other overall investor protections are in place today and companies may, as a result, face unreasonable burdens when also seeking to comply with current Nasdaq Stock Market shareholder approval requirements.

Under Nasdaq Stock Market Rule 5635, shareholder approval is required for the issuance of stock in connection with, among other actions:

- the acquisition of the stock or assets of another company;
- a change of control; and
- certain private placements at a price less than the greater of book or market value of such stock.

Nasdaq is soliciting comments on whether in each of these cases a more expansive view on whether shareholder approval is required should be considered. The current Nasdaq Stock Market rules and what Nasdaq is seeking input from the public on are summarized below.

Acquisition of Stock or Assets

Nasdaq Stock Market Rule 5635(a) generally requires a listed company to obtain shareholder approval in connection with an acquisition if the potential issuance is equal to (1) 20 percent or more of the number of shares of common stock or voting power outstanding, or (2) 5 percent of the number of shares of common stock or voting power outstanding, in cases where insiders have an interest in the target entity.

Nasdaq has asked the public to comment on whether these rules should be modified in both instances to increase the percentage of shares issuable without shareholder approval.

Change of Control

Nasdaq Stock Market Rule 5635(b) requires shareholder approval prior to the issuance of shares when the issuance (or potential issuance) will result in a change of control. In determining whether an issuance will potentially result in a change of control, Nasdaq Stock Market rules consider the voting power, ownership and board representation of investors receiving shares in the transaction. The Nasdaq Stock Market rules also consider all facts and circumstances concerning a transaction, including whether there are any relationships or agreements between the company and the investors, or among the investors. The rules generally deem a change of control to occur when, as a result of the issuance, an investor or a group of investors would own, or have the right to acquire, 20 percent or more of the outstanding shares of common stock or of the voting power and such ownership or voting power would be the largest position.

Nasdaq has asked the public to comment on whether:

- the current 20 percent threshold is appropriate and if not, what level of ownership or voting power should represent a change of control;
- a bright-line test or safe harbor would be beneficial to investors and companies to define when a change of control would occur;
- there are other definitions of a change of control (such as in accounting literature or securities law) that should be used to determine if a change of control would occur;
- whether a higher threshold is required if an investor publicly discloses an intent, or enters into a covenant, to remain passive and not exert control of the listed company; and
- there are other factors to be considered when determining if a transaction results in a change of control.

Private Placements

Nasdaq Stock Market Rule 5635(d) requires listed companies to obtain shareholder approval prior to the issuance of common stock (or securities convertible into common stock) equal to 20 percent or more of the common stock or voting power outstanding at a price less than the greater of book or market value of the stock. In determining the market value of the stock, Nasdaq rules look to the closing bid price of the stock. The rules also require shareholder approval if stock is issued to insiders in a private placement at a discount to market value. The rules do not require shareholder approval if the issuance is a "public offering"; in determining whether an issuance is a public offering, Nasdaq will consider (1) the type of

offering, (2) the manner in which the offering is marketed, (3) the extent of the offering's distribution, (4) the offering price, and (5) the extent to which the company controls the offering and its distribution.

In certain circumstances, Nasdaq Stock Market rules will aggregate transactions to determine whether shareholder approval is required. When determining whether or not to aggregate two or more transactions, the rules look at the (1) timing of the issuances, (2) facts surrounding the initiation of the subsequent transaction(s), (3) commonality of investors, (4) existence of any contingencies between the transactions, (5) specified use of proceeds for each of the transactions, and (6) timing of the board of directors' approvals. Generally, Nasdaq rules do not aggregate transactions that are more than six months apart.

Nasdaq has asked the public to comment on whether:

- the company's closing bid price should be used to measure market value, or if another measure should be used;
- the book value measurement should be eliminated;
- an exception should be created for smaller companies to issue a higher percentage of stock without shareholder approval and if so, what should constitute a "smaller company";
- companies should be permitted to obtain pre-approval to issue shares on a periodic basis without being subject to the rule at the time of each issuance;
- insiders should be permitted to purchase stock without shareholder approval if participating on the same terms as other investors purchasing at a discount to market value;
- a sliding scale approach should be adopted, which allows for more shares to be issued without shareholder approval if the issuance is at a nominal discount to the market value (and less shares to be issued without shareholder approval if at a significant discount);
- the factors used to determine if an offering is a "public offering" are appropriate;
- a bright-line rule should be adopted in determining whether to aggregate transactions; and
- the shareholder approval requirements should be modified for issuers with a stable shareholder base (this is premised on the idea that a stable shareholder base of long-term holders is an indication of implied approval by shareholders of how a company is managed and that companies with such support should be afforded greater autonomy).

While the ultimate modifications to the Nasdaq Stock Market rules governing shareholder approval remain to be seen (and any proposed modification will also be subject to review by the U.S. Securities and Exchange Commission), Nasdaq's desire to proactively overhaul a possibly outdated set of rules

should be viewed positively. In the 25 years since the current rules were first adopted, a variety of other shareholder protections have been enacted. These include requirements for independent directors to comprise the majority of the board of public companies and stronger governance practices by companies to protect against shareholder litigation.

While some of the protections the current Nasdaq rules provide may be redundant to other rules today, another factor motivating Nasdaq to consider changes may be that the costs and burden of complying with the current rules may be inhibiting certain public companies from participating in merger and acquisitions and capital-raising activities that ultimately could be beneficial to their shareholders.

Given current capital markets dynamics, it is wise for Nasdaq to be soliciting input from the public on whether a more nuanced approach to when shareholder approval for stock issuances should be required. Irrespective of any modifications that may be made to the Nasdaq Stock Market rules, however, state law will always also still need to be considered and may independently require the approval of shareholders for certain types of transactions. For example, approval by stockholders of Delaware corporations is required (pursuant to Section 251 of the General Corporation Law of the state of Delaware) if the surviving Delaware corporation in a merger issues more than 20 percent of its outstanding stock as part of the transaction.

—By Kristopher D. Brown, Thomas J. Friedmann, David S. Rosenthal and Shashi Khiani, Dechert LLP

Kristopher Brown is a partner in Dechert's New York office.

Thomas Friedmann is a partner in Dechert’s Boston office and co-chairman of the firm's global corporate finance and capital markets practice.

David Rosenthal is partner in New York and co-chairman of the global corporate finance and capital markets practice

Shashi Khiani is an associate in the firm's Washington, D.C., office.

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