FREQUENTLY ASKED QUESTIONS ABOUT RIGHTS OFFERINGS

Background

What is a rights offering?

A rights offering typically provides an issuer's existing shareholders the opportunity to purchase a *pro rata* portion of additional shares (also referred to as "subscription warrants") of the issuer's stock at a specific price per share (the "subscription price"), which is typically set at a discount to the recent trading price of the issuer's stock.

How are rights distributed?

All shareholders are given the right to purchase shares based on the number of shares they own on a specified record date, so there is no dilutive effect to shareholders who exercise the rights issued to them.

Does a rights offering require shareholder approval?

Because there is no dilutive effect, stock exchange rules do not require issuers to obtain shareholder approval for issuances of 20% or more of the outstanding shares at a discount to current market value in connection with a rights offering.

How long does the offering period remain open?

The rights offering is typically open for a period of 16 to 30 days, usually starting from the day that the issuer's registration statement relating to the rights offering becomes effective. There are no federal securities laws requiring the rights offering to be open for a specified period of time.

Can the rights be transferred?

Most rights offerings involve non-transferable rights. If a shareholder decides not to exercise its non-transferable rights, the shareholder's ownership in the issuer will be diluted by those shareholders who exercise their rights. However, an issuer may elect to structure an offering to permit rights to be transferable. In transferable rights offerings, shareholders who choose not to exercise their transferable rights can trade them in the secondary market during the offering period. The money earned from trading the rights provides compensation to shareholders who do not wish to participate in the rights offering by enabling the shareholders to offset dilution by earning a profit trading the rights.

How are transferable rights traded?

Trading of the transferable rights takes place on the exchange where the issuer's common stock is listed, or over the counter if the issuer's stock is not listed on an exchange.

What is a "step-up privilege"?

A "step-up privilege" may be offered to shareholders when the rights are not easily divisible by the subscription ratio. In such situation, if a shareholder fully exercises the rights, the shareholder will be permitted to subscribe for one additional full share in lieu of the fractional share that would have been granted, without furnishing any additional rights.

What is an "over-subscription privilege"?

An "over-subscription privilege" provides a shareholder who fully exercises the rights, including any "step-up privilege," if applicable, to subscribe for an additional number of shares, usually not more than the aggregate number of shares subscribed for pursuant to the basic rights and the "step-up privilege." The "over-subscription privilege" is subject to allotment, and shares will be distributed on a *pro rata* basis if allotment does not exist to fulfill all requests.

How are shares obtained through an "over-subscription privilege" distributed?

The *pro rata* distribution can be handled in one of the following two ways: (1) as nearly as practicable in proportion to the shares requested; or (2) as a ratio, in that the rights exercised by each shareholder exercising the "over-subscription privilege" bears to the total number of rights exercised by all shareholders exercising the "over-subscription privilege."

Types of Rights Offerings

What is a direct rights offering?

In a direct rights offering, there is no backstop commitment party, or standby purchaser. Instead, the issuer only sells the number of shares evidenced by the exercised rights. A direct rights offering is cheaper than an "insured" rights offering (or standby rights offering) because there are no fees associated with providing the backstop commitment. However, a poorly subscribed direct rights offering may leave an issuer under-capitalized.

What types of issuers would benefit most from a direct rights offering?

Large, well-capitalized issuers who are looking to raise capital but do not have a specific capital raising goal or who are established enough to expect many shareholders to exercise their rights may benefit from a direct rights offering. Also, issuers that have identified interest from an existing shareholder, or shareholders, may benefit from a direct rights offering.

What is an "insured" rights offering?

In an "insured" rights offering (also referred to as a standby rights offering), a third party (usually an underwriting syndicate, an investment bank, an affiliate of the investment bank or an affiliate of the issuer) agrees, prior to the commencement of the rights offering, to purchase any shares or rights that are not exercised in the rights offering. This arrangement is commonly known as a "backstop commitment" or a "standby commitment," and provides the issuer with a guarantee that it will raise the necessary capital. If the rights offering is structured as a standby rights offering, the issuer will enter into an agreement with the party agreeing to provide the backstop, or standby, commitment.

When should an issuer consider a standby rights offering?

An issuer should consider structuring a rights offering as a standby offering if the issuer must raise a specific amount of capital. By entering into an agreement with a standby purchaser, the issuer can ensure that it raises the necessary amount of capital even if all shareholders do not subscribe for their full allotments of shares. If an issuer does use a standby purchase agreement, the issuer should factor fees into the amount of the offering to make sure enough shares are offered to meet its capital needs.

An issuer also may consider a standby rights offering if the issuer's stock price is volatile. This is because the offering period is usually at least 16 days but can extend up to 30 or 45 days. Most shareholders will wait until the end of the subscription period to decide whether to exercise their rights. If the shares are trading in the market for the same or less than the subscription price, then shareholders will not exercise their rights. The issuer has to consider where to set its subscription price to avoid this, while not selling the shares at too steep of a discount price. Entering into a backstop commitment can mitigate this issue.

What fees are associated with a backstop commitment?

As compensation for shifting the risk from the issuer if there is an under-subscription, the backstop commitment party is paid a flat standby fee, plus a per share amount for each unsubscribed share purchased by it after the subscription offer expires and for each share purchased by it on the exercise of rights purchased in the secondary market, if the rights are transferable. In the event that a rights offering is under-subscribed and the subscription price is below the market price, the backstop commitment party usually agrees that any profits it makes from the backstop commitment will be split with the issuer.

Are there any requirements to be a backstop commitment party?

There is no broker-dealer licensing requirement for backstop commitment parties, although most are investment banks or an underwriting syndicate formed by an investment bank. However, one or more substantial investors will sometimes agree to act as a backstop commitment party. Without a broker-dealer license, substantial investors cannot engage in activities to mitigate the risk of an under-subscription. Usually, though, substantial investors do not mind the risk of having to increase their holdings in the issuer.

Preparation and Considerations in Connection with a Rights Offerings

What steps must be taken prior to conducting a rights offering?

A rights offering requires advance planning and preparation. The issuer must take a number of actions within a certain time frame, including, but not limited to, the following: providing documentation to shareholders; providing information to shareholders; marketing the rights offering to shareholders; collecting exercise certificates and payment from shareholders; and filing documentation with the SEC and the applicable stock exchange.

What corporate actions must be taken prior to conducting a rights offering?

The issuer must determine if it has sufficient authorized and unissued shares to accommodate the number of shares that could be issued in connection with the rights offering. If not, the necessary corporate actions must be taken to authorize new shares.

Whether or not the issuer has adequate capital authorization, the issuer will have to hold a board of directors meeting to take the following corporate actions: (1) authorize the rights offering; (2) set the record date to determine the shareholders of record entitled to participate in the rights offering, usually the effective date of the registration statement; (3) set an offer date; and (4) set an expiration date for the offer period.

The issuer must determine if other events or activities requiring a record date will be approaching, such as a record date for an annual shareholders meeting, or dividend distribution. This is to ensure that there are not conflicting shareholders of record for two different events or activities occurring around the same time period. Once the record date is set for the rights offering, no other record date for any other purpose should be set by the issuer for at least seven business days after the expiration of the offering period.

What additional considerations should be taken into account in connection with a standby rights offering?

If an issuer chooses to conduct a standby rights offering, it should consider who will be the backstop commitment party, often referred to as the "standby purchaser," and the amount of the commitment, which will be based on the issuer's financing needs.

In a standby rights offering, the issuer may want to put a cap on the number of shares that the backstop commitment party may acquire in order to avoid an inadvertent change of control.

In a standby rights offering, especially one involving transferable rights, a market may develop for the rights that may create arbitrage opportunities (between the issuer's common stock and the rights) or price volatility in the issuer's common stock.

In a standby rights offering, any unsubscribed shares that are purchased by the backstop commitment party that will be resold in the secondary market must be sold pursuant to a prospectus. Pursuant to Regulation S-K, the prospectus (or prospectus supplement) must contain: (1) the results of the rights offering; (2) the transactions by the backstop commitment party during the offering period; (3) the amount of unsubscribed shares being purchased by the backstop commitment party; and (4) the terms of any subsequent reoffering thereof. If the terms of the subsequent offering differ from those on the face of the underlying prospectus, a post-effective amendment must be filed setting forth the new terms.

Regulatory Requirements for Rights Offerings

Must the issuer make any SEC filings for a rights offering?

Once an issuer determines that there are an adequate number of authorized shares available for the rights offering, the issuer must make certain Exchange Act filings.

Does the issuer have to register the rights with the SEC?

Because the rights are rights granted to existing shareholders for no consideration, the rights do not need to be registered with the SEC; however, the issuer must register the shares that will be allocated to the shareholders who elect to participate in the rights offering.

Are there any instances when rights need to be registered?

In certain circumstances, rights may need to be registered. In a transferable rights offering, if a controlling shareholder chooses to trade rights rather than exercise them, the requisite number of rights would need to be registered and a statement would need to be included in the prospectus stating that the prospectus may be used to cover the sales of rights by such controlling shareholder.

What SEC filings are necessary for the shares offered pursuant to the rights offering?

The issuer must file a registration statement on Form S-1 or Form S-3, if eligible. Or, if an issuer has an effective existing shelf registration statement, the issuer can review it to determine if it provides sufficient authority to conduct a rights offering. The issuer must also file a prospectus or prospectus supplement, as the case may be, with the SEC prior to delivering one to each shareholder.

What SEC filings are required for rights offerings conducted by a foreign private issuer?

If the issuer is a foreign private issuer at the time the securities are first offered to U.S. holders, with limited U.S. ownership, the rights offering is exempt from registration, provided certain conditions provided in Rule 801 of the Securities Act are met. Rule 801 limits transferability of the rights by U.S. shareholders unless in accordance with Regulation S, and requires certain documentation be provided to U.S. shareholders.

Are there any additional securities laws that relate specifically to rights offerings?

With the adoption of Regulation M, there is no longer a separate rule covering market manipulation during rights offerings. Therefore, if a rights offering involves a distribution as defined in Rule 100, the applicable restricted period of Rules 101 and 102 applies to bids for or purchases of the security being distributed and any reference security. Transactions involving the rights themselves are not subject to Rules 101 or 102. However, Rule 104 applies to stabilization transactions in any security, including the rights. Contractual provisions should be included in rights and standby purchase agreements to ensure purchasers do not violate this rule, and to protect the issuer from liability.

Stock Exchange Requirements for Rights Offerings

What exchange rules govern rights offerings?

- *NYSE Rule 703.03(B); NASDAQ Rules 4310(c)(16) and 4320(e)(14)*. The exchanges require all known terms and details of a proposed rights offering to be publicly released immediately after the issuer's board of directors has taken action.
- *NYSE Rule 703.03(B) NASDAQ Rules 4310(c)(25) and 4320(e)(21)*. The exchanges require at least ten days' advance notice of any record date fixed in connection with an offering of listed securities to shareholders.

- *NYSE Rule 703.03(C)*. The NYSE requires issuers to send written notice to shareholders at least ten days in advance of the proposed record date. The notice should state that the issuer intends to make a rights offering. The notice should also include to the extent finally determined: (1) the title of the security to be offered; (2) the proposed subscription ratio; (3) the proposed subscription price; (4) the proposed record date for determination of those entitled to subscribe; (5) the proposed expiration date of the right to subscribe; and (6) the expected date on which the subscription certificates will be mailed.

- *NYSE Rule 703.03(E)*. The NYSE requires that shareholders of listed securities be allowed at least sixteen days after the rights have been mailed to subscribe to the offering, although it could be reduced to fourteen days if certain mailing conditions are met. Further, it is recommended that subscription certificates be issued to stockholders as soon as practicable after the record date.

- *NYSE Rule 703.03(M)*. The NYSE requires that the issuer notify it by telephone immediately upon receiving notice that the registration of the offered securities has become effective.

- *NYSE Rule 703.03(N)*. The NYSE requires issuers to list rights, if they are transferable, in addition to listing the new shares on the exchange.

- *NYSE Rule 703.03(A)*. It is recommended that the issuer confer with its exchange representative well in advance of the offering date to ensure coordination of actions and arrangement of a time schedule.

- *NYSE Rule 703.03(D)*. It is recommended that (1) the effective date be set for at least six business days in advance of the record date in order to prevent confusion if there is a delay in the effectiveness of the registration statement, unless the issuer already has an effective shelf registration statement; (2) the issuer's board of directors establish the record date as a specified date "or such later date as registration under the Securities Act of 1933 shall become effective;" and (3) once the record date is set for the rights offering, no other record date for any other purpose should be set by the issuer for at least seven business days after the expiration of the offering period.

Third Parties Involved in Rights Offerings

What type of third parties are hired to assist an issuer conducting a rights offering?

Unless the issuer is a large corporation or has a highly concentrated shareholder base, it will most likely seek assistance from third parties. Depending on the size of the issuer and the type of rights offering, the issuer may engage a dealer-manager, a subscription agent, and/or an information agent. The issuer also may engage an investment bank (underwriter) to act as the standby purchaser.

What does the dealer-manager do?

Usually a dealer-manager is hired to market the rights offering and solicit the exercise of rights and participation in the over-subscription privilege, if any. In a non-transferable rights offering, issuers may opt to avoid marketing expenses and sales commissions by doing this themselves.

What does a subscription agent do?

Usually, a subscription agent is hired to send a prospectus or prospectus supplement, as the case may be, and a right to each existing shareholder, and to collect all of the completed subscription certificates and related payments from the shareholders. This role may be filled by an issuer's transfer agent.

What does an information agent do?

Usually, an information agent is hired to answer any shareholder questions and provide further information about the rights offering. If the issuer has an adequately staffed investor relations department, a third party may not be required for this task.

Advantages and Disadvantages of Conducting a Rights Offering

From an issuer's perspective, what are some of the advantages of conducting a rights offering compared to a PIPE transaction or a follow-on public offering?

Unlike a PIPE transaction or follow-on public offering, there is no shareholder approval necessary even if the rights offering results in an issuance of common stock representing 20% or more of the voting power outstanding prior to the issuance. Because shareholder approval is not required, rights offerings can be completed more quickly than other forms of financing, which is useful for issuers wanting to take advantage of a market window or needing a quick cash infusion due to liquidity issues.

Because shareholder approval is not required, rights offerings can be a cheaper source of pre-filing and post-filing capital raising for issuers contemplating, or emerging from, chapter 11 bankruptcies. Unlike post-petition debt financing, there are no financial covenants or similar restrictions attached to the capital, and the capital often can be raised for less cost.

Because the offering is made to existing shareholders and not to the general public, less marketing is required, and, as a result, the rights offering can be less expensive than a PIPE transaction or follow-on public offering, and possibly less time consuming. Sales commissions for a dealer-manager in a rights offering are often less than underwriting discounts in follow-on offerings. And due to the offering being limited to shareholders, roadshows are less frequent and less expensive.

The announcement of a rights offering can trigger market interest in the issuer's common stock with prospective investors interested in purchasing shares prior to the record date in order to take advantage of the offering.

From an issuer's perspective, what are some of the disadvantages of conducting a rights offering compared to a PIPE transaction or a follow-on public offering?

If the rights offering is conducted as part of a broader capital raising effort, due to securities law and stock exchange rules, additional filings or procedures may be required that eliminate the financial benefits and time savings associated with a rights offering.

The sale of shares in a rights offering can result in more concentrated investor positions.

The sale of shares to outside investors as part of a backstop commitment arrangement can give effective control to outsiders without existing shareholders receiving a control premium for their shares.

From a shareholder's perspective, what are some of the advantages of a rights offering compared to a PIPE transaction or a follow-on public offering?

A rights offering provides shareholders with an opportunity to make an additional investment in the issuer, usually at a discount to market price.

A rights offering enables shareholders to avoid being diluted by the issuance of new equity.

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