LATHAM & WATKINS

Number 1053 July 14, 2010

Client Alert

Latham & Watkins Corporate Department
Capital Markets Group

Upsizing and Downsizing Your IPO

The reds have been printed; the deal is on the road; and the champagne is on ice. Now, all that is left is for the IPO investors to step up and buy the stock. It's a tempting moment to relax — but an experienced deal lawyer knows better. This is the time to start preparing for the possibility that the deal will be wildly oversubscribed or will struggle mightily. In either case, the question that will shortly come your way is "How much can the deal be upsized or downsized at pricing?"

To answer that seemingly simple question, you will need to break it into three component parts:

- Was your registration statement accurate and complete as of the time it became effective?
- Have you provided investors with all the information they need to make an informed investment decision prior to confirming orders?
- Do you owe the SEC any additional filing fees?

Getting to the bottom of these points is a surprisingly complex undertaking. The rules in this area are technical and not always intuitive, and you may be asked to make some difficult judgment calls under significant time pressure. The purpose of this *Client Alert* is to provide you with the tools you need to react quickly and wisely to questions about pricing outside the range when the moment of truth arrives.

"The purpose of this *Client Alert* is to provide you with the tools you need to react quickly and wisely to questions about pricing outside the range when the moment of truth arrives."

Getting Started: The Importance of the Earlier Filings

Let's start with a review how you got to where you are now.

When you first filed the registration statement, you had to complete the "Calculation of Registration Fee" table on the front cover. The primary purpose of the fee table was to calculate the amount of filing fees required to be paid to the SEC at that time. Several amendments later, when your deal was ready to go to investors, a preliminary prospectus was filed showing the number of shares expected to be sold and a "bona fide" estimate of the price range per share as required by Regulation S-K Item 501(b)(3). That range was very likely a $2 range, in keeping with the informal SEC Staff policy for deals expected to price below $20 per share (if the upper limit is above $20 per share, the informal policy is that a price range of up to 10 percent of the upper limit is bona fide). The price range prospectus was circulated to investors at the beginning of the road show.

Now, the deal is on the road. Investor feedback is rolling in. If investor demand is stronger than anticipated, the issuer and the selling stockholders may want to sell more shares or increase the price per share being sold, or both. On the other hand, if a crisis in some far-away part of the world happens to come to

Latham & Watkins operates worldwide as a limited liability partnership organized under the laws of the State of Delaware (USA) with affiliated limited liability partnerships conducting the practice in the United Kingdom, France, Italy and Singapore and as affiliated partnerships conducting the practice in Hong Kong and Japan. Latham & Watkins practices in Saudi Arabia in association with the Law Office of Mohammed Al-Sheikh. Under New York's Code of Professional Responsibility, portions of this communication contain attorney advertising. Prior results do not guarantee a similar outcome. Results depend upon a variety of factors unique to each representation. Please direct all inquiries regarding our conduct under New York's Disciplinary Rules to Latham & Watkins LLP, 885 Third Avenue, New York, NY 10022-4834, Phone: +1.212.906.1200. © Copyright 2010 Latham & Watkins. All Rights Reserved.

roost while your deal is on the road, the underwriters may have to struggle to complete a smaller deal, involving fewer shares or a lower price per share, or both. Let's review the tools in your toolbox for upsizing or downsizing your deal.

Options Prior to Effectiveness

Until your registration statement has been declared effective by the SEC, you can revise your deal all you want in a pre-effective amendment with a new price range and/or a new number of securities to be sold. You may need to pay additional filing fees if you are upsizing, but it's no problem to do so. If demand is through the roof, this may be an option to consider.

However, using a pre-effective amendment to upsize or downsize a deal after the price range prospectus has been distributed to investors is typically a last resort in our experience. Among other things, there can be unwelcome timing implications (for example, you will need to obtain a new auditor's consent and updated signature pages and clear any comments from the SEC Staff on the new disclosure). In addition, the new filing containing the amended price range could send a signal to the market about pricing that may be premature. Particularly for deals that are in trouble and may need to be downsized, refiling the registration statement with a revised price range can spell disaster.

Options After Effectiveness

Those who qualify for the special treatment offered by Rule 430A and the related rules will find it much more attractive to make the necessary changes to the terms of the deal after effectiveness.[1] In most cases, therefore, the question for the deal team will be whether the proposed changes to the number of shares to be sold and the price per share qualify for Rule 430A's magic? Put another way, the key question is this:

> *"Assuming we go effective on a registration statement containing the same price range prospectus that was circulated to investors, how far can the deal be upsized or downsized at pricing and after effectiveness without having to go back to the SEC for permission?"*

In order to understand the magic of Rule 430A, you will need to master the interplay between several key provisions of the Securities Act and a number of rules and Compliance and Disclosure Interpretations (C&DIs) published by the SEC Staff. Once you have mastered these rules, you will need to answer these three questions:

- Is the "Section 11 file" complete as of the effective time of the registration statement?
- Is the "Section 12 file" complete as of the time you want to start confirming orders?
- Do you owe the SEC any more filing fees?

Section 11 and Section 12

Let's start with a few words about the primary liability provisions of the Securities Act.

Section 11(a) of the Securities Act imposes liability if any part of a registration statement, at the time it became effective, "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." Section 11 liability only covers statements made in a registration statement *at effectiveness*. We think of the registration statement at the magic moment of effectiveness as the "Section 11 file." This is a helpful way to remember that Section 11 is a highly technical provision, in the sense that it looks only at: (a) what is or is deemed to be in the registration statement (b) at the time it became effective.[2]

By contrast, Section 12(a)(2) of the Securities Act is not limited to the registration statement and is not linked to the moment of effectiveness. It imposes liability on any person who offers or sells a security in a registered offering

by means of a prospectus, or any oral communication, which contains "an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading." Section 12(a)(2) is less technical and more holistic than Section 11. Section 12(a)(2) takes into account all oral statements, free writing prospectuses and statements in the price range prospectus, rather than focusing exclusively on the registration statement.

Under Securities Act Rule 159 (which we discuss in greater detail below), Section 12 looks to the sum of *what investors have been told at the time the underwriters confirm orders*. Section 12's focus, therefore, is the price range prospectus sent to investors and any additional information that may have been conveyed to investors (orally or in writing) on or before the time of pricing. We think of this collection of information as the "Section 12 file."

In order to deal with all of the issues that arise in the context of changing the size and price of an IPO after the registration statement has been declared effective, you will need to keep in mind both your "Section 11 file" and your "Section 12 file."

Rule 430A

Rule 430A is a very special rule. It permits a registration statement to be declared effective without containing final pricing information. Instead, it allows you to insert information retroactively into a registration statement and have it be treated as if it were there as of its effective date. Rule 430A provides that pricing-related information (which includes the price per share and the number of shares offered) that is contained in a prospectus filed pursuant to Rule 424(b) after effectiveness of the registration statement will be *deemed* to have been part of the registration statement *as of the effective date*. In other words, Rule 430A allows you to tinker with your "Section 11 file" *after the fact* and have the changes travel backwards in time.

Rule 430A is a particularly useful tool for complying with Section 11, and we are going to review all of its glorious twists and turns below. Keep in mind, however, Rule 430A's two important limitations. First, it only applies to pricing information.[3] And second, Rule 430A does not help you make corrections to your "Section 12 file," as it does not allow you to retroactively add to the information actually given to investors at the time of pricing.

Here is a summary of Rule 430A from a 40,000 foot perspective:

If you are...	**Then you should use...**	**And you can...**	**But you would need to...**
Upsizing your deal	Instruction to Rule 430A(a)	Increase the price per share and/or number of shares, so long as the aggregate size of the revised deal does not exceed *120 percent* of the amount shown in the fee table in the registration statement at the time of effectiveness	• File an immediately effective registration statement under Rule 462(b) to register the increase in shares/increase in deal size • Consider whether additional disclosure (oral or by means of a free writing prospectus) needs to be delivered to purchasers prior to confirmation of sale

If you are...	**Then you should use...**	**And you can...**	**But you would need to...**
Downsizing your deal	C&DI 627.01	Decrease the price per share and/or decrease the number of shares sold, so long as the size of the revised deal is not less than the lower end of the deal size reflected in the price range prospectus minus 20 percent of the maximum deal size reflected in the price range prospectus	• Consider whether additional disclosure (oral or by means of a free writing prospectus) needs to be delivered to purchasers prior to confirmation of sale

Now that you have the big picture, let's go through it again at a more granular level.

Instruction to Rule 430A(a)

Rule 430A's most important contribution to pricing outside the range is found in the instruction to paragraph (a), which states (in full):

> *Instruction to Paragraph (a)*. A decrease in the volume of securities offered or change in the *bona fide* estimate of the maximum offering price range from that indicated in the form of prospectus filed as part of a registration statement that is declared effective may be disclosed in the form of prospectus filed with the Commission pursuant to Rule 424(b) or Rule 497(h) under the Securities Act so long as the decrease in the volume or change in the price range would not materially change the disclosure contained in the registration statement at effectiveness. Notwithstanding the foregoing, any increase or decrease in volume (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b)(1) or Rule 497(h) if, in the aggregate, the changes in volume and price represent **no more than a 20 percent change in the maximum aggregate offering price set forth in the "Calculation of Registration Fee" table in the effective registration statement**. [Emphasis added.]

In other words, where the 20 percent safe harbor threshold is not exceeded, changes in price and deal size can be poured backwards in time into the registration statement using a Rule 424(b) filing of the final prospectus *after* the effectiveness of the registration statement and will be *deemed* to have been part of the registration statement at the time it became effective for purposes of Section 11. This is a very useful device indeed. It allows you to change the size of your deal by 20 percent in either direction without having to go back to the SEC. This timing advantage is critical when you are trying to price a deal. As a result, understanding the exact scope of this 20 percent safe harbor is critical.

C&DI 227.03 (January 26, 2009)

C&DI 227.03 reads (in full) as follows:

> **Question**: A registrant omits pricing information from the prospectus in a registration statement at the time of effectiveness in reliance on Rule 430A. Is it required to reflect pricing information or the inclusion of additional securities in a post-effective amendment?

> **Answer**: The second sentence of the Instruction to Rule 430A provides that a Rule 424(b) prospectus supplement may be used, rather than a post-effective amendment, when the 20% threshold is not exceeded, **regardless of the materiality or non-materiality of resulting changes to the registration statement disclosure that would be contained in the Rule 424(b) prospectus supplement**. When there is a change in offering size or deviation from the price range beyond the 20% threshold noted in the second sentence of the Instruction, a post-effective amendment would be required only if such change or deviation materially changes the previous disclosure. Regardless of the size of the increase, in the case of a registration statement that is not an automatic shelf registration statement, a new registration statement must be filed to register any additional securities that are offered. Additional securities cannot be registered by post-effective amendment except on automatic shelf registration statements. [Emphasis added.]

This C&DI establishes two important points:

- For purposes of Rule 430A (and hence the Section 11 file), retroactive changes in price within the 20 percent threshold can be made after the fact by way of a Rule 424(b) prospectus *even if the effects of those changes are material,* and
- Even changes outside the 20 percent threshold can be made using a Rule 424(b) prospectus if the changes *do not materially change the disclosure.*

These are important points — and not entirely intuitive — so let's spend another minute here. Rule 430A effectively lets you make pricing-related changes to your registration statement without SEC review (*i.e.*, without filing a post-effective amendment) even if those changes are material. This special privilege is limited to pricing information as contemplated by Rule 430A, but it is a very special privilege nevertheless. The second point is equally important — changes in excess of 20 percent may not be material.

How can this be, you ask? Good question. Consider, for example, a $1 billion offering that is half primary and half secondary shares. If the secondary shares are reduced to $250 million, but the primary shares stay at $500 million, the offering has been reduced by 25 percent but the reduction may well not be material. There will still be a very substantial public "float" after the offering and the proceeds to the issuer (and hence the use of proceeds), the pro forma number of shares outstanding and the pro forma earnings per share will not change at all. This sort of fact pattern is right in the center of C&DI 227.03's fairway.

C&DI 627.01 (April 24, 2009)

So far, so good. It all seems pretty clear — Rule 430A allows you to go up or down 20 percent from the maximum aggregate offering price reflected in the fee table. But one key question remains unresolved:

What does Rule 430A have to say about the deal size *actually reflected in the prospectus circulated to investors*, as opposed to the maximum deal size reflected in the fee table? What if (as is often the case) these two amounts are not aligned?

This is where C&DI 627.01 comes into play. C&DI 627.01 reads (in full) as follows:

> **627.01** The instruction to paragraph (a) of Rule 430A provides that changes in volume and price representing no more than a 20% change in the maximum offering price set forth in the registration statement fee table may be made pursuant to a Rule 424(b)(1) prospectus supplement. **The 20% threshold may be calculated using the high end of the range in the prospectus at the time of effectiveness and may be measured from either the high end (in the case of an increase in the offering price)**

> **or low end (in the case of a decrease in the offering price) of that range**. [Emphasis added]

C&DI 627.01 permits you to calculate the 20 percent amount for purposes of downsizing your deal in a very favorable way. As an alternative to the 20-percent-of-the-amount-in-the-fee-table approach contemplated by the instruction to paragraph (a) of Rule 430A, C&DI 627.01 allows you to derive your 20 percent amount by multiplying the upper end of the range in the price range prospectus by 20 percent.[4] You can then add that amount to the upper end of the range in the price range prospectus if you are upsizing, or subtract that amount from the bottom of the range if you are downsizing, to figure out what share count and price per share will be within the safe harbor. Since 20 percent of the upper end of the price range is by definition greater than 20 percent of the lower end of the price range, C&DI 627.01 effectively broadens the scope of the Rule 430A safe harbor for troubled deals.

The approach in C&DI 627.01 represents an alternative to the approach in the instruction to paragraph (a) of Rule 430A, and the SEC Staff takes the positions that you cannot "mix and match" between the C&DI and the instruction to paragraph (a). As a result, if you are following C&DI 627.01 you may not take 20 percent of the amount reflected in the fee table and subtract that from the lower end of the price range, even though that might yield a lower floor on your transaction than 20 percent of the upper end of the range (since the fee table often registers a larger transaction than the upper end of the range). Either you calculate using the fee table or you calculate using the range in the price range prospectus, but you can't have it both ways. In practice, this means that you will want to use C&DI 627.01 when downsizing and the instruction to paragraph (a) of Rule 430A when upsizing.

The Section 12 File and the Importance of Common Sense

Knowing whether you are within the Rule 430A safe harbor is not the end of the analysis — after all, the Rule contemplates that there could be *material changes to the disclosure* that would fall within the safe harbor. Rule 430A is a fabulous tool for dealing with the Section 11 file, but it doesn't help you with the Section 12 file. Let's tackle the Section 12 file now.

Securities Act Rule 159; Free Writing Prospectuses; Exchange Act Rule 15c2-8(b)

Rule 159, which was introduced as part of the securities offering reforms that became effective in 2005, adds an important wrinkle to the Section 12 landscape. Rule 159 makes clear that, for purposes of Section 12, information conveyed to a securities purchaser after the time of sale does not count for purposes of determining whether the Section 12 file was complete at the moment that liability attaches. In other words, Section 12 liability is a function of what you actually gave or told the purchaser prior to confirming the order — anything delivered after the moment of truth does not count.

This means that those material pricing changes that can be retroactively poured into the Section 11 file after the fact under Rule 430A must actually be conveyed to purchasers in real time prior to confirming orders in order for the Section 12 file to be up to snuff. There are a number of ways to transmit the required information — the rules are agnostic as to the actual method of conveyance — but the key point is that the conveyance must be made and it must be made prior to confirming orders.

Market practice is that simple information that can be effectively reduced to sound bites is conveyed orally. It is customary in deals pricing within the range, for example, to convey

the final pricing information orally. Oral conveyance is also used in many upsizing and downsizing scenarios. The easiest example of this would be a 20 percent decrease in deal size in an all-secondary offering by a selling stockholder. All the investor needs to know in that case is how many shares are being sold and at what price — there are no collateral disclosure implications to the change in deal size in that example.[5] The disclosure in the price range prospectus will not otherwise change at all.

More complicated deal changes may require that a free writing prospectus summarizing the changes be circulated to accounts in writing as contemplated by Rule 433. An example of this situation might be a decrease in offering size that results in a change to the use of proceeds flowing through the pro formas. The decision whether to convey the new information orally or in writing will in part depend on whether the price range prospectus circulated to investors contained "sensitivity analysis" explaining how the company's plans would change if the actual proceeds turned out to be more or less than the amount assumed in the price range prospectus. The more sensitivity analysis that is included in the price range prospectus, the more likely it will be possible to convey the missing information orally at the time of pricing. This is a point to keep in mind in the early drafting sessions.

There is no hard-and-fast rule about how much sensitivity analysis will do, and what topics need to be covered. Some items to evaluate might include:

- Use of proceeds, particularly where stated uses would need to be changed or new uses added (for example, in the case of unexpectedly large proceeds)
- Pro forma earnings per share
- The size of the "float" after the offering
- The company's financial condition generally
- The level of beneficial ownership by members of senior management or other significant stockholders; and
- Dilution.

The goal is to have disclosure that allows investors to see how changes in share price or deal size ripple through critical elements of the disclosure. Ideally, the price range prospectus will present key disclosures in an "if/then" format ("We will apply the net proceeds from this offering first to repay all borrowings under our credit facility and then, to the extent of any proceeds remaining, to general corporate purposes," for example).

Finally, where the changes are so fundamental that the original price range prospectus must be completely rewritten, it may be necessary to recirculate a completely new price range prospectus in order to satisfy Exchange Act Rule 15c2-8(b). Rule 15c2-8(b) requires that brokers and dealers participating in an IPO "deliver a copy of **the preliminary prospectus** to any person who is expected to receive a confirmation of sale at least 48 hours prior to the sending of such confirmation." [Emphasis added.]

The line between a complete recirculation and a supplemental circulation of changed pages is a blurry one. The free writing prospectus concept introduced by Rule 433 in the 2005 securities offering reforms was intended, we believe, to obviate the need for a full recirculation of a completely new price range prospectus in all but the most extreme cases. However, when changed pages become so pervasive that the original price range prospectus can no longer be said to be "the preliminary prospectus" within the meaning of Rule 15c2-8(b), then a full recirculation may be required. If the changes are less than pervasive, a free writing prospectus summarizing the changes should suffice.

The key import of this distinction between a full recirculation of a new price range prospectus and a supplemental circulation of a free writing prospectus summarizing the

changes relates to timing. If you have tripped the Rule 15c2-8(b) wire, you need to give investors 48 hours (generally thought to mean two full business days)[6] to consider the revised disclosure. If you are in free writing prospectus land, however, you may conclude that investors only need a few hours (or even minutes) to digest the new disclosure. The SEC Staff has, to date, refrained from offering any guidance on the question "How long is long enough?" as it relates to delivery of new information for purposes of Rule 159 and Section 12. The prevailing view among law firms is that most information can be digested upon receipt and only very complicated changes need a full business day to be absorbed. Somewhat complicated changes may need more than a few minutes to be digested but less than a full business day.

We continue to feel that the better view of Rule 433 and the free writing prospectus that it ushered in is that a properly crafted and conveyed free writing prospectus should eliminate the need for a full recirculation in all but the most extreme cases.[7]

Filing Fee Issues — Securities Act Rules 457 and 462(b)

Rule 457

Although Rule 457 deals with the seemingly mundane issue of the calculation of the registration fee, the choice you make under Rule 457 will have a significant impact on your options at the moment of truth.

Remember that you initially filed your registration statement with a fee table, calculated either:

- Under Rule 457(o) on the basis of the amount of proceeds the issuer wanted to raise, or
- Under Rule 457(a) on the basis of the number of shares to be sold and a bona fide estimate of the sale price per share.

Chances are, you opted to calculate the registration fee for purposes of the fee table under Rule 457(o). You could have used Rule 457(a) instead, but since doing so would let the market know the likely per share price (*i.e.*, maximum deal size divided by the number of shares registered), most deal teams opt to use Rule 457(o).[8] It's unusual in our experience for a deal team to elect to tip its hand about the expected price per share at the time the registration statement is first filed.

When the time comes to file your price range prospectus, you have a choice: either keep using Rule 457(o), or refile your fee table under Rule 457(a).

If you choose to refile under Rule 457(a), you will not have to pay more filing fees if your offering price per share later increases — that's baked right into the text of the Rule. You will, however, be required to pay additional filing fees if you later increase the *number* of shares to be offered, even if the total offering size (number of shares sold times sale price) does not go above the original estimate used to calculate the original filing fee. The added shares will need to be registered — we discuss below how that is done.

If you stick with Rule 457(o), you will not have to file a new registration statement and pay additional filing fees if your per share price goes down and you increase the number of shares offered so as to maintain the original aggregate offering price. *See* C&DI 640.05. You will, however, be required to pay additional filing fees if you keep the same number of shares and increase the per share price (thereby increasing the aggregate deal size).

Which route is preferable? Refiling under Rule 457(a) allows you to increase the price per share (but not the number of shares) without filing an additional registration statement. By contrast, staying with Rule 457(o) allows you to increase the number of shares and decrease the price per share so as to maintain overall deal size, without filing an additional registration statement.

So it all boils down to whether you think you will be upsizing price only (and leaving the number of shares unchanged) or will be playing with both price and number of shares in order to keep the same total aggregate deal size. Many deal teams elect to switch to Rule 457(a) at the time of printing the price range prospectus, because increasing the price per share at pricing is a more likely outcome than increasing the number of shares and decreasing the price.

Rule 462(b)

How do you go about adding additional shares (if you are using Rule 457(a)) or increasing the deal size (if you are using Rule 457(o))? You will need to file an immediately effective registration statement under Rule 462(b).[9]

Rule 462(b) is available if:

- You file the new registration statement prior to the time confirmations are sent, and
- The increase in price and share count together represent an increase of no more than 20 percent of the previous maximum aggregate offering price (as set forth in the fee table at effectiveness).[10]

There is a curious wrinkle to how the 20 percent amount is calculated for purposes of Rule 462(b), again depending on whether you refiled your fee table under Rule 457(a) or stayed with Rule 457(o). If you are using Rule 457(a), you multiply the number of *additional* shares by the new offering price and then look to see whether the increase in deal size associated with the added shares is more or less than 20 percent of the deal size in the fee table at effectiveness — even though that fee table was calculated at the old price per share. See C&DI 640.03. To take an example, imagine that your fee table at effectiveness reflected 11.5 million shares and a price range of $8-$10 per share, for a maximum aggregate deal size of $115 million. At pricing, the number of shares is increased by 1.5 million and the price is increased to $12 per share. The number of additional shares *times* the price *equals* $18 million. Since this is less than 20 percent of $115 million (*i.e.*, $23 million), you could use Rule 462(b) to register the new shares. The fact that the entire deal is actually being upsized by more than 20 percent (since $115 million *plus* 20 percent *equals* $138 million, and 13 million shares *times* $12 per share *equals* $156 million) is disregarded if you are using Rule 457(a).

The calculation is done differently if you are staying with Rule 457(o). In that case, you multiply *all* of the shares being offered (including the additional shares) by the new price per share and then look to see if you have increased total deal size by more than 20 percent. *See* C&DI 640.04. This makes sense, since Rule 457(o) looks to total deal size. To use our example above, 20 percent of the original maximum deal size equals $23 million. Because 13 million shares are being offered at a new price per share of $12, total deal size would be $156 million, which is more than the original deal size *plus* 20 percent ($115 million *plus* $23 million *equals* $138 million). As a result, you could not use Rule 462(b) to register the additional deal size above 20 percent.

Some Examples of How It All Fits Together

Is your head spinning at this point? It should be. Let's start with the following basic facts and then try various upsizing and downsizing scenarios to help illustrate how the rules work:

- Maximum aggregate deal size in the fee table at effectiveness is $115 million
- The price range prospectus reflects a range of $8-$10 per share, 10 million firm commitment shares and 1.5 million greenshoe shares, for a total of 11.5 million shares (including the greenshoe)[11]
- The minimum aggregate deal size in the price range prospectus is $92 million (including the greenshoe), while the maximum aggregate deal

size in the price range prospectus is $115 million (including the greenshoe)

Scenario 1: At pricing, the price is increased to $12 but the number of shares stays the same, for a total aggregate deal size of $138 million (post greenshoe).

This is within Rule 430A's safe harbor, because the increased price per share (from $10 to $12) when multiplied by the number of shares (10 million plus the 1.5 million greenshoe shares) yields a maximum aggregate deal size ($138 million) that does not exceed the maximum aggregate offering size reflected in the fee table plus 20 percent ($115 million *plus* $23 million *equals* $138 million). (You include the greenshoe shares in these calculations, because you need to have registered and paid fees for all securities sold in the offering.) You can ignore the price range prospectus for the moment, since the instruction to Rule 430A(a) says you look to the maximum deal size in the fee table to calculate the 20 percent amount for purposes of upsizing. The fee table will always reflect a total deal size that is greater than or equal to the deal size reflected in the price range prospectus (at least if you used Rule 457(o) to compute the fee table), so you can see why the instruction is the way to go in an upsizing scenario — you get to calculate the 20 percent off a bigger base and hence get a larger increase.

Because you are within Rule 430A, the new deal size and share price will be deemed to be part of the Section 11 file at the time the registration statement became effective once the final prospectus is filed under Rule 424(b). The Section 12 file can be handled with an oral statement to accounts at the time of confirming orders to the effect that the price is now $12 per share and the maximum deal size is $138 million (post greenshoe). Ideally, the price range prospectus already disclosed what the proceeds would be used for if the deal raised more cash than originally assumed, so there is no need to elaborate on that point.

There would be no need to pay additional fees via a Rule 462(b) registration statement if you calculated your filing fee for purposes of the fee table using Rule 457(a), because the number of shares to be sold has not changed — this, as we pointed out above, is the primary benefit of Rule 457(a). If you calculated your filing fee using Rule 457(o), on the other hand, you would need to register the additional deal size, and this could be done by filing a Rule 462(b) registration statement.[12]

Scenario 2: At pricing, the price is increased to $14 and the number of shares is increased to 12 million (pre greenshoe) and 13.8 million (including the greenshoe), for a total aggregate deal size of $193.20 million (post greenshoe).

This is outside the Rule 430A safe harbor, since the new total maximum aggregate deal size ($193.20 million) is more than 20 percent above the maximum deal size reflected in the fee table ($115 million *plus* $23 million *equals* $138 million). That's not the end of the story, of course. Remember that C&DI 227.03 permits you to pour this information back into the Section 11 file at the time of effectiveness via a Rule 424(b) prospectus even if your deal size changes by more than the 20 percent safe harbor amount, if the increase in deal size does not materially change the disclosure. You might be able to conclude that the changes were immaterial — for example, if the sensitivity analysis in the price range prospectus gave investors enough information to track the changes through the disclosure.

The Section 12 file will also need to be addressed. This can be done either with an oral statement to accounts at the time of confirming orders or by distributing a Rule 433 free writing prospectus prior to confirming orders to those expected to purchase shares. The decision whether to convey the new information orally or in writing (via a free writing prospectus) will depend on the complexity of the changes.

Finally, don't forget that you would need to register additional shares and pay additional fees, whether you used Rule 457(a) (since the number of shares being registered has increased) or Rule 457(o) (as a result of the increase in transaction size). On our facts, if you refiled under Rule 457(a) at the time of printing the price range prospectus you would not be able to register the additional shares via an immediately effective Rule 462(b) registration statement, because the additional number of shares (2.3 million) multiplied by the new price per share ($14) equals $32.20 million, which is more than 20 percent of the maximum offering price at effectiveness ($23 million). Similarly, if you used Rule 457(o) you would have to file a new registration statement under Rule 462(b), since the increase in total deal size (from $115 million to $193.20 million) is greater than 20 percent.

> **Scenario 3: At pricing, the price is decreased to $6 but the number of shares stays the same, for a total aggregate deal size of $69 million (post greenshoe).**

At first glance, this might appear to be outside the Rule 430A safe harbor since the new total maximum aggregate deal size ($69 million) is less than the maximum deal size reflected in the fee table minus 20 percent ($115 million *minus* $23 million *equals* $92 million). But remember C&DI 627.01, which allows you to focus on *the price range in the price range prospectus rather than the amount reflected in the fee table*. Following C&DI 627.01, you would calculate the 20 percent threshold by using the high end of the range (20 percent of $115 million *equals* $23 million) and then deducting that amount from the low end of the range ($92 million). This approach ($92 million *minus* $23 million) lets you reduce the deal to $69 million with the greenshoe, and gives you maximum flexibility. C&DI 627.01 is your best choice in a downsizing scenario — you get to decrease deal size beyond the level that the instruction to Rule 430A(a) would otherwise allow. The decreased pricing information can be included in a Rule 424(b) prospectus and will be deemed to be part of the Section 11 file at effectiveness.

The Section 12 file issues may well be more interesting in this example, depending in part on whether the disclosure in the price range prospectus included sensitivity analysis explaining what the issuer would do if the deal got downsized to such an extent. If it did, an oral explanation of the smaller deal size may be sufficient to provide investors with the missing information. If not, particularly if the use of proceeds will need to change, a free writing prospectus summarizing the changes may be advisable.

Because there is no increase in aggregate deal size or number of shares being offered, there is no need to pay additional fees or file a Rule 462(b) registration statement. In fact, the question whether additional filing fees are due never comes up in a downsizing scenario.

> **Scenario 4: At pricing, the price is decreased to $4 but the number of shares is increased, for a total aggregate deal size of $69 million (post greenshoe).**

The answer to this scenario is the same as scenario 3, since both yield a minimum deal size of $69 million. In other words, the aggregate size of the deal did not decrease by more than 20 percent (calculated using the C&DI 627.01 methodology) because of the increase in the number of shares to be sold. We believe that the SEC Staff would consider this scenario to be within Rule 430A, notwithstanding the steep decrease in the per share price (from $8 to $4).[13]

Some Additional Things to Bear in Mind

Negative Assurance Letter Practice

Negative assurance letter practice among law firms changed following the adoption of the Securities Act reforms in 2005, particularly because of Rule 159's

focus on the information in investors' hands at the time of pricing. Negative assurance letters now cover three important items:

- The registration statement as of its effective date, as measured against the requirements of Section 11 of the Securities Act
- The final prospectus, as of its date and as of the closing date, as measured against the requirements of Section 12 of the Securities Act, and
- The "Pricing Time Disclosure Package" as of the time the underwriters commence to confirm orders, as measured against the requirements of Section 12 of the Securities Act.

This last bullet point was added to address Rule 159. It requires the negative assurance provided by the issuer's and the underwriters' law firms to speak to the collection of information conveyed to prospective purchasers at the time the underwriters begin to confirm orders. The magic of Rule 430A and its permission to go back in time to rewrite history is critical for the negative assurance given in the first bullet point above, which relates to the Section 11 file, but it is of no use for purposes of the third bullet point, which relates to the Section 12 file.

The way to satisfy Rule 159 is to actually convey information to accounts. In the context of a deal that is being upsized or downsized at the last minute, conveying information — or even preparing the information so that it can be conveyed — may not be easy to do in a timely manner. As a result, the deal team will be under pressure to make important materiality judgments on a real-time basis.

FINRA Issues

IPOs are subject to FINRA Rule 5110 (sometimes referred to as the Corporate Financing Rule). The underwriters of your IPO will be FINRA members, and the Corporate Financing Rule will limit the amount of compensation they (and other distribution participants for that matter) may receive in connection with the IPO. The Corporate Financing Rule also prohibits certain practices that FINRA has determined to be "unfair or unreasonable" and contains filing and disclosure requirements.[14]

If the type of compensation going to the underwriting group consists only of the "spread" (*i.e.*, the discount off the public offering price), the upsizing or downsizing of an IPO should not trigger additional issues under Rule 5110. However, Rule 5110 includes many other "items of value" received by the underwriters around the time of the IPO in the calculation of aggregate underwriting compensation. If aggregate underwriting compensation exceeds a certain percentage of the total offering proceeds, the underwriters may need to obtain the FINRA "no objections" opinion required by the SEC in order for the registration statement to be declared effective. A change in the size of your deal could potentially change the total underwriting compensation as a percentage of deal proceeds in a manner that would require a visit to FINRA. In practice, that may be difficult to achieve under the timing pressure that always exists at the moment of truth.

FINRA Rule 2720 contains additional requirements that apply to public offerings in which a participating FINRA member is deemed to have a "conflict of interest" (*i.e.*, an interest in the outcome of the offering beyond its role as an underwriter or selling group member). The rule provides that a conflict of interest exists whenever five percent or more of the net offering proceeds will be directed to a FINRA member or its affiliates or other "related persons." Accordingly, if an offering is downsized, you will need to re-assess whether the conflict of interest provisions of Rule 2720 are triggered. Among other things, Rule 2720 will generally require the participation of a FINRA-approved "qualified independent underwriter" and inclusion of prominent disclosure as to the nature of the conflict in the prospectus.

NYSE/Nasdaq Issues

Both the NYSE and the Nasdaq's listing rules exempt "controlled companies" — that is, companies of which more than 50 percent of the voting power is held by an individual, a group or another company — from certain listing requirements relating to corporate governance. For example, controlled companies are exempt from the requirement to have a board composed of a majority of independent directors. When you are doing an IPO for a controlled company, you should keep an eye out for the potential effect of selling more shares on the controlled company analysis — if your deal is upsized at the moment of truth, it's possible that the company will not longer be "controlled" for purposes of this exemption.

Tying It All Together

So how does all of this fit together, you ask? Simple, really. The underwriters and the issuer should start the dialogue about how the market is reacting to the deal while the road show is progressing. These are the types of questions that may come up:

- Is there sufficient demand for the stock within the suggested range?
- If not, is it possible to get a smaller deal done within the range or may we need to reduce the deal's size and the per share price?
- If the size of the deal decreases, will the use of proceeds need to change?
- Is there sufficient excess demand that we can increase the price to a price that is above the top end of the range?
- Can we increase the price above the range and increase the number of shares being offered?
- If the deal size increases, what will the extra proceeds be used for?
- What did we say in the price range prospectus sent to investors about what would happen to our use of proceeds if the deal were to be upsized or downsized?

It is important to get this dialogue going long before it is time to price the deal so the deal team can plan for every possible outcome. Bear in mind that:

- A free writing prospectus reflecting new disclosures may need to be drafted and circulated to prospective investors expected to purchase stock in the offering before orders can be confirmed, or a telephone script for the conversation with those investors may need to be prepared
- A final prospectus containing appropriate disclosure must in any event be drafted and filed under Rule 424(b)
- The accountants' comfort letters may need to change to reflect the revised disclosure
- A Rule 462(b) registration statement to register additional shares or transaction size may need to be prepared, and extra filing fees may need to be paid
- A Rule 462(d) post-effective amendment to add a new Exhibit 5.1 opinion covering additional shares may need to be drafted and filed
- If there are other changes that do not qualify as pricing information within the meaning of Rule 430A or if Rule 430A's 20 percent safe harbor is not available, a post-effective amendment to the registration statement may need to be prepared and filed, and the SEC Staff must declare it effective, and
- In the most extreme cases, an entirely new price range prospectus must be drafted and recirculated to all investors expecting to purchase stock in the offering.

All these steps take time. There is no substitute for advance planning, which comes in two phases — before and during/after the road show. *Before the road show*, it is very handy if the price range prospectus is drafted to include appropriate sensitivity analysis along the lines discussed above. Good advance planning and carefully crafted disclosure in the price range prospectus may make it possible to conclude that a change in deal size is not a material change in the disclosure, taken as a whole. *During and after the road show*, as soon as it becomes clear that an upsizing or downsizing is even a possibility, the deal team should be reviewing the

options under the rules described above and preparing revised disclosure, free writing prospectuses, telephone scripts, etc., as needed.

Timing is critical and there is little margin for error. Be prepared!

Summary

This is tricky stuff. However, with appropriate advance planning and carefully crafted disclosure in the price range prospectus, it is possible to navigate the many technical requirements and focus on the judgment calls. What is a material change to the disclosure depends in part on what was disclosed in the first instance, so the advance planning really begins at the first drafting session. Those who are thinking ahead to pricing from the very beginning will have an easier time when they get there, even if the deal changes materially at the moment of truth.

Endnotes

[1] Remember, though, that there are situations in which you may conclude that filing a pre-effective amendment is unavoidable. One example would be where you are certain before effectiveness that your deal is going to be dramatically downsized or upsized: failing to refile exposes you to the risk of tripping over Regulation S-K Item 501(b)(3), which requires an IPO issuer to include a "bona fide estimate" of the price range in the preliminary prospectus it circulates to potential investors. In the ordinary course, you would seek to go effective at some point prior to the close of the stock market — 2:00 p.m. Eastern time is often chosen. Because the market has not yet closed, you would typically not be in a position to know with certainty that you will be pricing outside the range set forth in the prospectus at that time.

[2] The time of "effectiveness" is a key moment in the IPO. Among other things, securities cannot be sold until the registration statement is declared effective. Rule 430A allows an IPO to price as many as 15 business days after effectiveness, but it is most common to price on the day of effectiveness (which is also the time the underwriters will begin confirming orders). The actual closing of the transaction happens some number of days later.

[3] Rule 430A defines pricing information as:

> information with respect to the public offering price, underwriting syndicate (including any material relationships between the registrant and underwriters not named therein), underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds, conversion rates, call prices and other items dependent upon the offering price, delivery dates, and terms of the securities dependent upon the offering date[.]

[4] We're assuming that the prospectus at effectiveness is the same price range prospectus circulated to investors — in other words, that you have not refiled with a different range.

[5] Note, however, that one consequence might be a material change to the ownership structure, for example if the change resulted in a control group's retention (or loss) of control over the company.

[6] In other words, if prospective investors actually have the revised preliminary prospectus in their hands at 9:00 a.m. on Monday morning, it would be appropriate to price on Tuesday after the market closes.

[7] One wrinkle in Rule 433 that could be construed to require a full recirculation in a very limited circumstance deserves discussion. Rule 433(b)(2)(i) requires that an IPO issuer's free writing prospectus be:

> accompanied or preceded by the most recent . . . [preliminary] prospectus [on file with the SEC]; *provided, however*, that use of the free writing prospectus is not conditioned on providing the most recent such prospectus if a prior such prospectus has been provided and there is no material change from the prior prospectus reflected in the most recent prospectus[.]

This proviso is puzzling, since in most cases there would not be a reason to circulate a free writing prospectus if there were nothing material to report. We choose, therefore, to interpret the proviso as meaning that a free writing prospectus for an IPO issuer is only allowed to convey material changes if the free writing prospectus *and the original preliminary prospectus* (and each other broadly distributed free writing prospectuses, if any), *taken together*, contain materially the same information as is at the time on file with the SEC. We think that this interpretation is more in keeping with the overall purpose of Rule 433 — namely, to encourage sending information to accounts on an as-needed, real-time basis.

In any event, however, note 1 to paragraph (b)(2)(i) of Rule 433 makes clear that this technical issue is not a problem for a free

writing prospectus delivered by e-mail as long as it includes a hyperlink to the most recent preliminary prospectus on file with the SEC. As a result of this helpful note, every free writing prospectus to be sent by e-mail in connection with an IPO should include such a hyperlink. In situations where the underwriters are able to distribute free writing prospectuses to all accounts by e-mail, there is no need to struggle with the interpretive issue discussed in the prior paragraph.

[8] There is a technical reason why it is generally preferable to chose Rule 457(o) at the outset. The SEC Staff informally takes the position that if you raise your price range in a preliminary prospectus contained in a pre-effective amendment from the range used to calculate the filing fee *and you originally elected to proceed under Rule 457(a)*, then the 20 percent safe harbor contemplated by the instruction to paragraph (a) of Rule 430A is calculated on the basis of the original maximum aggregate offering price and not the offering price range contained in the price range prospectus distributed to investors. This qualification can be eliminated if you "voluntarily" pay an additional filing fee when you increase your offering range, but doing so defeats the primary benefit of Rule 457(a) (*i.e.*, you do not need to go back to the SEC if you increase your estimated price per share). This SEC Staff position can be a trap for the unwary issuer who elected to use Rule 457(a) originally to calculate the filing fee and later seeks to upsize. There is no such hidden problem for users of Rule 457(o), as they are required to pay additional filing fees at the time they upsize their deal, and they know it.

[9] You will also need to remember to include a new Exhibit 5.1 opinion on the legality of the additional securities being registered. This can be done by means of an immediately effective post-effective amendment under Rule 462(d).

[10] Note, by the way, that Rule 462(b) works for an increase in transaction size in a Rule 457(o) deal, even though the text of Rule 462(b) speaks only of "registering additional securities." *See* C&DI 640.04.

[11] The "greenshoe" is jargon for the underwriters' over-allotment option — that is, the contractual right to purchase some number of additional shares from the issuer after the closing of the offering. "It is so named because it was first used in connection with a 1963 secondary offering of shares of common stock of The Green Shoe Manufacturing Company, the Boston-based manufacturer of Stride-Rite shoes (not green shoes for leprechauns as some have supposed)." Charles J. Johnson, Jr. and Joseph McLaughlin, *Corporate Finance and the Securities Laws* at 2-38 (4th ed. 2009).

[12] When calculating the increase in deal size for Rule 462(b) purposes, do not overlook the underwriters' overallotment option – you will need to register a sufficient number of shares (and pay enough fees) to cover both the primary as well as any option shares to be sold in the IPO.

[13] Having said that, you would need to be comfortable that the price range in the price range prospectus circulated to investors (and included in the registration statement at the time of effectiveness) was in fact a "bona fide" price range as required by Regulation S-K Item 501(b)(3).

[14] Among other things, the Corporate Finance Rule limits the greenshoe to 15 percent of the amount of securities being offered in the IPO (excluding the greenshoe). See FINRA Rule 5110(f)(2)(J).

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

Alexander F. Cohen
+1.202.637.2284
alex.cohen@lw.com
Washington, D.C.

Kirk A. Davenport
+1.212.906.1284
kirk.davenport@lw.com
New York

Joel H. Trotter
+1.202.637.2165
joel.trotter@lw.com
Washington, D.C.

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the attorney with whom you normally consult. A complete list of our *Client Alerts* can be found on our website at www.lw.com.

If you wish to update your contact details or customize the information you receive from Latham & Watkins, please visit www.lw.com/LathamMail.aspx to subscribe to our global client mailings program.

Abu Dhabi
Barcelona
Beijing
Brussels
Chicago
Doha
Dubai
Frankfurt
Hamburg
Hong Kong
Houston
London
Los Angeles
Madrid
Milan
Moscow
Munich
New Jersey
New York
Orange County
Paris
Riyadh*
Rome
San Diego
San Francisco
Shanghai
Silicon Valley
Singapore
Tokyo
Washington, D.C.

* In association with the Law Office of Mohammed A. Al-Sheikh