# INSIGHTS

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SECURITIES OFFERINGS

# Baby Shelf Rules Explained

***By Scott D. McKinney***

A company with $75 million or more in aggregate market value of its voting and nonvoting common equity held by non-affiliates, or public float, may sell in a primary offering on Form S-3 an unlimited amount of equity securities for cash pursuant to General Instruction I.B.1 of Form S-3.

However, if an issuer has less than $75 million in public float, it may sell in a primary offering on Form S-3 no more than an amount equal to one-third of its public float during any 12-month period under General Instruction I.B.6 of Form S-3. Instruction I.B.6 and Securities and Exchange Commission (SEC) Staff guidance related thereto are often referred to as the "baby shelf" rules. This article discusses compliance with the baby shelf rules and strategies related to living under the baby shelf rules.

## Eligibility Conditions for Baby Shelf Issuers

In addition to meeting the general Form S-3 issuer eligibility conditions discussed below, an issuer intending to conduct an offering under I.B.6 must have a class of common equity that is listed on a national securities exchange. No such restriction exists for an issuer conducting an offering under I.B.1, which may be listed on OTC or pink sheets. An I.B.6 issuer must also not be or have been a shell company (including a "blank check" company) for at least the 12 previous calendar months (and if it was a shell company, it must have filed current Form 10 information with the SEC at least 12 calendar months previously reflecting that is not a shell company).

Baby shelf issuers must also meet the general Form S-3 eligibility conditions. Form S-3 may only be used by (1) a US domestic issuer with (2) a class of securities registered under Section 12(b) or 12(g) of the Securities Exchange Act of 1934, as amended (Exchange Act), or which is required to file reports under Section 15(d) of the Exchange Act, and (3) which has been subject to such requirements for at least the last 12 calendar months, and (4) which has filed in a timely manner all reports required to be filed during the preceding 12 calendar months, other than pursuant to certain items of Form 8-K, and (5) which has met all debt and dividend obligations in the prior 12 months.

## Instruction I.B.6. Allows Smaller Issuers Take Advantage of a Shelf Offering

While the one-third of public float offering limitation of I.B.6 is very restrictive, an issuer subject to I.B.6 may use Form S-3 as a shelf registration statement. In a shelf registration, the issuer may offer a maximum dollar amount of one or more types of securities that may be offered over a period of time in the future in one or more offerings after the registration statement becomes effective. Shelf offerings are conducted using the base prospectus in the original Form S-3 filing and a prospectus supplement that is filed in connection with a takedown offering. The initial filing of the S-3 shelf registration statement with the base prospectus is subject to SEC Staff review. However, once the S-3 shelf registration with base prospectus is declared effective, subsequent takedowns are not subject to SEC Staff review and may be timed based on market conditions.

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## What Is Public Float and How and When To Calculate It Under Form S-3

Public float for Form S-3 is calculated as the number outstanding shares of voting and nonvoting common equity held by non-affiliates multiplied by the market price of the common equity, as determined under Form S-3 rules. SEC rules provide that an affiliate of an issuer is a person that "controls, or is controlled by, or is under common control with, such issuer." SEC rules define "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."

Ascertaining who are affiliates requires a facts and circumstances determination but is generally understood to include at least an issuer's executive officers, directors, holders of 10 percent or more of the common equity, and stockholders who have board representation. Also generally considered held by affiliates are any additional shares that affiliates are deemed to beneficially own under Rule 13d-3 that are outstanding. Note that outstanding shares do not include treasury shares or shares issuable upon exercise or conversion of any derivative securities. Restricted shares (but not restricted stock units, which do not reflect outstanding shares) that are not beneficially owned by affiliates are included in public float.

The calculation of public float is used to determine when an issuer qualifies to use I.B.1 because public float is $75 million or more and, if public float is less than $75 million, the one-third of public float offering size limitation under I.B.6. With this in mind and based Form S-3 rules discussed below, an issuer will need to calculate its public float in relation to four dates in connection with a shelf registration on Form S-3: (1) the date the S-3 registration statement is filed; (2) the date of a Section 10(a)(3) prospectus update, which is typically the date the Form 10-K (or Form 20-F for foreign private issuers) is filed; (3) the date of a takedown offering from the shelf, when subject to I.B.6; and (4) any date public float exceeds $75 million, while subject to I.B.6.

### Calculate Public Float When Filing Form S-3

Public float must be calculated in relation to the date a Form S-3 is filed. If you are conducting an immediate offering on Form S-3 (including an immediate continuous offering on Form S-3), this calculation need only be made in relation to the date of filing the S-3. If you are conducting a delayed shelf-offering, there are additional times the public float calculation may need to be performed, as discussed further below.

To calculate the public float in relation to the filing date of a Form S-3, you look at the price at which the common equity was last sold, or the average of the bid and asked prices of such common equity, in the principal market for such common equity as of a date within 60 days prior to the date of filing the S-3, per the instruction to I.B.1. That price is then multiplied by the number of outstanding shares of common equity held by non-affiliates. In making this computation, it is not necessary to calculate the number of shares held by non-affiliates for the same day on which the average price of the stock is determined per compliance and disclosure interpretation (C&DI) 116.01. For example, the number of shares outstanding on the date of filing might be used, together with the average price of stock for any day within the 60-day period.

If a shelf registration on Form S-3 qualifies for an unlimited sized offering under I.B.1 at the time the S-3 is filed, a take-down can occur under I.B.1, even if public float subsequently drops below $75 million, at least through the time of the next Section 10(a)(3) prospectus update, at which time the S-3 must requalify as to form.

If an issuer does not qualify to conduct an offering under I.B.1. at the time it files an S-3 registration statement, then the Form S-3 is subject to the offering size restriction of I.B.6. Even if no immediate offering is contemplated, the issuer must include the disclosure specified in instruction 7 to I.B.6 in its base prospectus. Instruction 7 provides that registrants must set forth on the outside front cover of the prospectus the public float calculated pursuant to I.B.6. and the amount of all securities offered

pursuant to I.B.6. during the prior 12 calendar month period that ends on, and includes, the date of the prospectus. If a company files an S-3 shelf that appears subject to I.B.6 but does not include this information, the SEC Staff may comment that the information must be provided if the S-3 is subject to I.B.6.

The disclosure required by Instruction 7 to I.B.6. does not itself directly or indirectly constitute a maximum offering size for an S-3 shelf registration statement. The SEC confirmed in Release 33-8878 (Example A) that an S-3 shelf registration statement subject to I.B.6 can be filed for a maximum amount that exceeds the one-third limit of I.B.6., although any takedown under I.B.6 is subject to the one-third limit.

The disclosure required by Instruction 7 to I.B.6. is also not that useful for a Form S-3 shelf offering, as the public float, depending on timing of a takedown, will likely need to be recalculated at the time of any particular takedown for purposes of the one-third limit of I.B.6. What the information required by instruction 7 provides is disclosure that offerings under the S-3 shelf are subject to I.B.6. No other S-3 objective disclosure rule covers this ground.

### Calculate Public Float at Section 10(A)(3) Prospectus Update

If at the time of the Section 10(a)(3) prospectus update, public float is calculated at below $75 million, future take-downs from that shelf registration statement of primary offerings for cash are limited to the restrictions under I.B.6. In calculating the public float in connection with a Section 10(a)(3) prospectus update, a registrant can use any day during the 60-day "look back" period from the filing date of the Form 10-K, per C&DI 116.07, in calculating public float. As with the public float calculation at the time of filing the S-3, the date used to determine price and the date used to determine shares held by non-affiliates need not be the same day.

A company that files an S-3 under I.B.1 but becomes subject to I.B.6 in connection with a Section 10(a)(3) prospectus update need not file a post-effective amendment solely to include the information required by Instruction 7 to I.B.6. This information may be included on the outside front cover of the prospectus via a prospectus supplement per C&DI 216.13. This prospectus supplement is sometimes referred to as a baby shelf sticker.

Some practitioners suggest that prior takedowns under I.B.1 that are continuous offerings, such as an at-the-market offering, become subject to I.B.6., if the S-3 shelf subsequently becomes subject to I.B.6 in connection with a 10(a)(3) prospectus update. However, that is not the case. A takedown that occurs under I.B.1 is forever subject to I.B.1, and a takedown that occurs under I.B.6 is forever subject to I.B.6, regardless of changes to public float of the issuer. This has been confirmed by the SEC Staff informally by telephone.

### Calculate Public Float When Conducting a Takedown Offering If Subject to I.B.6

If an offering is under I.B.6, to determine the amount of securities that a registrant may sell in connection with the intended takedown, the registrant calculates its public float as of a date within 60 days prior to the anticipated date of sale, pursuant to Instruction 1 to I.B.6.

It has been reported that the SEC Staff has informally confirmed that the date of sale in context of a takedown is the date of the preliminary prospectus supplement. The capacity available under the one-third limit in I.B.6 is measured immediately prior to the registered takedown and applies to the amount of securities offered for sale pursuant to the prospectus supplement, not the amount actually sold, according to C&DI 116.22.

### Calculate Public Float on Any Date It Exceeds $75 Million, While Subject to I.B.6

Under instruction 3 to I.B.6 of Form S-3 if the public float computed pursuant to I.B.6. equals or exceeds $75 million subsequent to the effective date of the registration statement, then the one-third limitation on sales specified in I.B.6 does not apply to

additional sales (that is, takedowns) made pursuant to the registration statement on or subsequent to such date and instead such registration statement is considered filed pursuant to General Instruction I.B.1.

The change in status does not impact prior takedowns. Such a company may sell securities pursuant to I.B.1 of Form S-3 without regard to the one-third limit of I.B.6 and without the need to recalculate its public float until, as discussed above, an updating amendment is filed to the Form S-3 (that is, at the time of filing of the next annual report on Form 10-K).

## Calculating Securities Sold Over the Past 12 Months Under I.B.6

After calculating public float for an offering under I.B.6, step two is calculating the amount of securities sold over the past 12 months and proposed to be sold under I.B.6.

### Only Primary Sales Made Under I.B.6 Count

Neither sales under I.B.1, nor private sales, nor secondary sales, nor any sales under a registration form other than Form S-3 count toward the one-third of public float offering limit under I.B.6. Only sales under I.B.6 looking back 12 months, and including the proposed offering, count. Thus, when an issuer first becomes subject to I.B.6, it will always have its full allowance of one-third of public float limit available.

### Non-Derivative Equity Securities

The aggregate amount of non-derivate equity securities sold under I.B.6 consists of the gross proceeds of such sales.

### For Completed Offerings, Only the Amount Actually Sold Counts

When measuring the amount available for a later takedown, for completed offerings only those securities actually sold under I.B.6 are counted against the one-third limit per C&DI 116.22.

### For Concurrent Continuous Offerings, the Amount That Continues to Be Offered Counts

In the context of multiple, concurrent continuous offerings, any securities that continue to be offered in other continuous offerings in reliance on I.B.6 would also count against the one-third limit per C&DI 116.23.

### I.B.6 Rolling Measurement Is Necessary for Different Takedowns, Not Individual Sales Within a Takedown

The capacity remaining under the one-third limit in I.B.6 is measured immediately prior to the registered takedown and applies to the amount of securities offered for sale pursuant to the prospectus supplement, not the amount actually sold, per C&DI 116.22. The concept of rolling measurement dates under I.B.6 is limited to different takedowns, not individual sales within a takedown. Thus, for example, the full amount of securities offered pursuant to an at-the-market offering subject to I.B.6. counts against the one-third limit.

### Primary Sales of Debt Securities Under I.B.6 Count

An issuer can offer debt securities under I.B.6. Such debt securities are included in the count of the aggregate market value of securities sold by the issuer under I.B.6. during the prior 12 calendar months, but obviously do not impact the calculation of public float. The SEC Staff noted in Release 33-8878 that it did not exclude debt offerings from the one-third limit because it did not want to inadvertently encourage issuances of debt securities over equity.

## Special Form S-3 Instruction for Valuing Derivative Securities Under I.B.6

No company likes being saddled with multiple series of warrants, which can limit share price growth. However, for a small capitalization company that may still be building out its operations, in order to close a public offering, it may be necessary to offer derivative securities, such as warrants. Form S-3

contains a special instruction for valuing derivative securities under I.B.6.

In the case of derivative securities convertible into or exercisable for shares of a company's common equity, companies are required to calculate the aggregate market value of any underlying equity shares in lieu of the market value of the derivative securities offered, per instruction 2 to I.B.6. The SEC noted in release 33-8878 that it believes calculating the one-third cap based on the market value of the underlying securities makes it less likely that convertible securities would be structured and offered in a manner designed to avoid the effectiveness of the one-third cap.

The aggregate market value of the underlying equity is calculated by multiplying the maximum number of common equity shares into which the derivative securities are convertible or for which they are exercisable as of a date within 60 days prior to the date of sale by the same per share market price of the company's equity used for purposes of calculating public float pursuant to Instruction 1 to I.B.6. Note that, counterintuitively, this price may be higher than the exercise price or conversion price of the derivative securities and higher than the price offered for any common stock included in the offering.

As an example, if a company has 3,000,000 shares held by non-affiliates and used a closing price of $2 per share that occurred 45 days before the takedown, the offering size under I.B.6. is limited to one-third of $6,000,000 or $2,000,000, assuming no prior I.B.6 sales during the prior 12 months. If the trading price drops to $1.50 before the takedown, such that underwriters suggest the company offer common stock at $1.50 per share accompanied one warrant per share with an exercise price of $1.50, keep in mind the warrants will need to be valued at $2 per warrant (that is, the same per share price used in calculating public float). In this example, the maximum number of shares of common stock and warrants that could be offered is 571,428 of each. 571,428 shares of common stock multiplied by $1.50 = $857,142. 571,428 warrants to purchase common stock at $1.50 per share multiplied by $2.00 = $1,142,856. Adding the common stock and the warrants, $857,142 plus $1,142,856 = $1,999,998, which is under the one-third offering cap of $2,000,000.

Notably, the warrants that were offered used up more than half of the I.B.6 offering cap, even though each share of common stock was accompanied by only one warrant. This can be demoralizing for the issuer, knowing the warrants will not bring in cash at the offering closing and may never be exercised. The underwriter may encourage everyone to keep their chin up, suggesting there wouldn't have been an offering closing at all if the warrants weren't included.

Assume that six months after the sale of common stock and warrants, the registrant proposes a subsequent takedown. To determine the amount of securities that the registrant may sell under I.B.6. in the proposed offering, the registrant must know its current public float and must calculate the aggregate market value of all securities sold in the last year on Form S-3 pursuant to I.B.6. With respect to the warrants that were sold in the prior takedown and have been exercised, instruction 2 to I.B.6 provides yet another valuation convention. The aggregate market value of the underlying common stock is calculated by multiplying the number of common shares for which the outstanding warrants were exercised times the market price *on the day of exercise*.

With respect to the warrants that were sold but have not yet been exercised, the aggregate market value of the underlying common stock is calculated by multiplying the maximum number of common shares for which the warrants are exercisable as of a date within 60 days prior to the anticipated new takedown by the per share market price of the registrant's equity used for purposes of determining its current float. Thus, the valuation of the warrants from the prior takedown, whether or not exercised, has likely changed, for purposes of calculating offering size availability under I.B.6.

Continuing the example, assume for a new takedown the registrant calculates a public float of $30,000,000 using a market price of $3 per share, such that offering size under I.B.6 is limited to $10,000,000. Assume

further that one-half of the warrants were exercised on a date the market price was $1.75 per share. Here, there are three buckets of securities that must be calculated to determine the aggregate market value of all securities sold in the last year on Form S-3 pursuant to I.B.6. First, you add 571,428 shares of common stock multiplied by their $1.50 sale price or $857,142. Second, you add the 285,714 warrants that were exercised on a date the market price was $1.75 per share or 285,714 * $1.75 = $499,999.50.

Third, you add the 285,714 warrants that have not been exercised multiplied by the price used to calculate the public float for the new takedown or 285,714 * $3 = $857,142. Assuming there was only the one prior takedown under I.B.6, the aggregate market value of all securities sold in the last year on Form S-3 pursuant to I.B.6 is thus calculated as $857,142 + $499,999.50 + $857,142 = $2,214,283.50. The registrant has room to offer under $10,000,000 - $2,214,283.50 = $7,785,716.50 in securities under I.B.6. in the proposed offering.

## Strategies to Consider When Subject to I.B.6 Or Anticipating Becoming Subject to I.B.6

While the best financing strategy for any particular public company depends on its unique facts and circumstances, if a listed public company is considering a public offering on Form S-3 and is subject to I.B.6 or anticipates becoming subject to I.B.6, there are certain strategies that should be kept in mind.

### S-3 Shelf Registration Maximum Amount Can Exceed I.B.6 One-Third Limit

If public float is less than $75 million at the time an S-3 shelf will be filed, keep in mind that it is permissible to register an amount of securities on a Form S-3 shelf registration statement that is greater than the amount that could be sold under an I.B.6 takedown at the time the S-3 is filed. While takedowns are subject to the one-third of public float limit under I.B.6., the shelf registration can be for a larger size. An issuer might do this because an S-3 shelf can last for three years, while the one-third look-back covers only 12 months at a time. An issuer might also do this, if the issuer thought its public float might increase above $75 million at a later date, thus regaining access to offerings under I.B.1.

### If Subject to I.B.6, Take It Easy on the Warrants, if Possible

Warrants do not bring in money at the closing of the offering but count against the one-third limit like shares of stock, subject to special calculation rules discussed above. Depending on marketing considerations, underwriters may want to include warrants on a one-to-one ratio with shares of stock. However, if this ratio can be dialed back, the registrant will have room to bring in more cash at closing of an offering under I.B.6.

### Monitor Changes in Public Float

The company's public float may increase because of an increase price of the stock or because it raises capital in equity offerings. If the company's public float rises, its one-third threshold also rises. Thus, a registrant may be able to raise more funds, even if it previously had raised the maximum based on its public float at an earlier date. This works the other way too, of course. If public float subsequently decreases, room that might have existed to conduct an offering under I.B.6 could be eliminated.

### Take Advantage of Initially Being Subject to I.B.1 If I.B.6 Is Looming

If a company is subject to I.B.1 when an S-3 shelf registration is filed and the company's public float subsequently drops below $75 million and appears that it may stay below $75 million at the next Section 10(a)(3) prospectus update, consider conducting a takedown prior to such 10(a)(3) update, maybe for an at-the-market offering up to the maximum size a company might expect to use while the shelf registration statement is still effective. If the company were to wait until after its Section 10(a)(3) update to do a takedown offering, the offering will then be subject to one-third limitation of I.B.6.

### Take Advantage of Regaining Access to I.B.1 After Being Subject to I.B.6

If an S-3 shelf registration statement is initially subject to I.B.6 or becomes subject to I.B.6 in connection with a Section 10(a)(3) prospectus update and the public float subsequently equals or exceeds $75 million, then the one-third limitation on sales specified in I.B.6 no longer applies to additional sales made pursuant to the registration statement on or subsequent to such date and instead the registration statement is considered filed pursuant to General Instruction I.B.1. The registration statement will remain subject to I.B.1, even if public float subsequently drops below $75 million, at least through the time of the next Section 10(a)(3) prospectus update.

### Concurrent Takedown and Private Offering with Resale Registration

In 2016, the SEC Staff via C&DI 116.25 eliminated the ability of an issuer to conduct a takedown under I.B.6 with a concurrent private offering to the same investors with resale registration under on a separate Form S-3 in reliance on Instruction I.B.3, if the aggregate number of shares sold exceeds the Instruction I.B.6 limitation that would be available to the issuer at that time.

Because the SEC Staff believes that this offering structure evades the offering size limitations of Instruction I.B.6, the securities registered for resale on Form S-3 should be counted against the issuer's available capacity under Instruction I.B.6. However, the SEC Staff noted the resale could be registered on Form S-1. If the issuer is a smaller reporting company, it could take advantage of both the historical and forward incorporation provisions of Form S-1, which make the Form S-1 similar to a Form S-3. While a takedown from Form S-3 is not subject to SEC Staff review, an offering on Form S-1 would be subject to SEC Staff review.

### Consider S-1 or Private Offering

If a company needs to register more than is permitted under I.B.6, consider conducting the entire offering as a registration on Form S-1 or as a private offering. However, note that Form S-1 cannot be used for a universal shelf. In order to register securities for a primary offering off of the "shelf" on a delayed or continuous basis, an issuer must be eligible to register on Form S-3 (or Form F-3) pursuant to Rule 415(a)(1)(x).