Corporate Finance Alert

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Meeting Demand: Upsizing & Downsizing Initial Public Offerings

In an initial public offering (IPO), a number of issues arise in connection with changing the number of shares to be sold or pricing above or below the price range that was previously disclosed in the preliminary prospectus[1] (Marketing Prospectus). Determining the necessary legal requirements requires a thorough, and sometimes complex, analysis that often must be undertaken under significant time constraints. The guidance below provides a practical roadmap for resolving issues related to upsizing or downsizing an IPO whether through changes in the number of shares to be sold and/or changes in pricing.

Rule 430A under the Securities Act of 1933 (Securities Act) provides that, for purposes of Section 11 liability, an issuer may upsize or downsize an IPO if the changes in volume and price represent no more than a 20 percent change from the maximum aggregate offering price set forth in the fee table in the effective registration statement. The method of calculating the 20 percent threshold differs depending on whether the issuer completes the fee table in accordance with Rule 457(a) or Rule 457(o). In certain instances, such as selling stockholder transactions, the 20 percent threshold may be exceeded where the upsize or downsize does not result in material changes to the disclosure set forth in the prospectus contained in the effective registration statement. Further, in any upsize or downsize scenario, the issuer should also be mindful of its Section 12 liability and the need to convey information related to the upsize or downsize to investors prior to confirmation of sale.

Original Proposed Offering Terms Set the Stage

In an IPO, the proposed offering terms required to be included in the Marketing Prospectus include (i) a "bona fide estimate" of the price range per share,[2] and (ii) the number of shares to be sold by the issuer and selling stockholders, as applicable.[3]

When making the initial filing of an IPO registration statement, an issuer is required to disclose the proposed maximum aggregate offering price in order to determine the amount of the registration fee to be paid.[4] If the issuer chooses to complete the table in accordance with Rule 457(o) under the Securities Act, the fee is calculated based on the maximum offering proceeds, without regard to the number of shares. If, on the other hand, the issuer elects to complete the table in accordance with Rule 457(a), the issuer must also disclose the number of shares offered and a bona fide estimate of the price per share in order to calculate the registration fee. This estimate of the price per share will be a definitive dollar amount, unlike the price range contained in the Marketing Prospectus.

For example, consider an issuer that seeks to raise $230 million in its IPO. Based on a bona fide estimate of a $10 per share price, the issuer will need to sell 23 million shares, which includes 3 million shares that may be sold pursuant to the underwriters' over-allotment option.

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Under Rule 457(o), the issuer may complete the fee table and disclose only the proposed maximum offering price of $230 million, as shown below:

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to Be Registered	Proposed Maximum Aggregate Offering Price(1)(2)	Amount of Registration Fee
Common stock, par value $0.01 per share	$230,000,000	$26,358

(1) Estimated solely for purposes of calculating the registration fee in accordance with Rule 457(o) under the Securities Act of 1933, as amended.

(2) Includes additional shares that the underwriters have the option to purchase pursuant to their over-allotment option, if any.

Under Rule 457(a), however, the issuer will need to include the proposed offering price of $230 million (based on its bona fide estimate of the price of $10 per share), as well as the 23 million shares proposed to be sold, in the fee table, as shown below.

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to Be Registered	Amount to be Registered(1)	Proposed Maximum Offering Price Per Share	Proposed Maximum Aggregate Offering Price(2)	Amount of Registration Fee
Common stock, par value $0.01 per share	23,000,000	$10	$230,000,000	$26,358

(1) Includes additional shares that the underwriters have the option to purchase pursuant to their over-allotment option, if any.

(2) Estimated solely for purposes of calculating the registration fee in accordance with Rule 457(a) under the Securities Act of 1933, as amended.

As discussed below, the decision to complete the fee table in accordance with Rule 457(a) or Rule 457(o) will have consequences for the issuer's ability to reflect an upsized or downsized offering in the final prospectus filed pursuant to Rule 424(b) under the Securities Act after the registration statement is declared effective (Rule 424(b) Prospectus).

Pre-Effective Amendment Filings Provide the Greatest Comfort but may not be Practicable

Before the SEC declares a registration statement effective, the issuer may file a pre-effective amendment to revise the proposed terms of the offering. This provides the greatest level of comfort that the prospectus is accurate at the time of effectiveness and eliminates the possibility that the registration statement has a material misstatement or omission.[5] However, more often than not, the decision to upsize or downsize an offering is generally not made until the proposed effective date (usually the pricing date of the offering). In such a case, there will not be time to prepare and file a pre-effective amendment to reflect revised offering terms and have the SEC staff review the registration statement and declare it effective within the time constraints of the offering. Therefore, it is critical for the working group to analyze whether the issuer may instead rely on the latitude provided by Rule 430A under the Securities Act to reflect the upsized or downsized offering in the Rule 424(b) Prospectus, which will be filed after the registration statement is declared effective.

Backwards Incorporation by Reference – Relying on Rule 430A for Section 11 Liability

Rule 430A permits a registration statement to be declared effective without containing the final pricing information. Rule 430A defines pricing information to include:

- the public offering price;
- the underwriting syndicate;
- underwriting discounts or commissions;
- discounts or commissions to dealers;
- the amount of proceeds;
- conversion rates, call prices and other items dependent upon the offering price; and
- delivery dates and terms of the securities dependent upon the offering date.

Rule 430A is very useful as it deems pricing-related information that is contained in the Rule 424(b) Prospectus to be included in the registration statement *as of the effective date* even though it was not filed with the SEC at the time of effectiveness. Rule 430A thus provides an elegant mechanism for issuers and underwriters to satisfy their obligations under Section 11, which requires a registration statement to include all material disclosures, including final pricing terms, at the time of effectiveness.[6]

Rule 430A minimizes the risk of a disruption in an issuer's offering schedule by providing both an administrative convenience to issuers and underwriters and significant flexibility to price an offering that is larger or smaller than that described in the Marketing Prospectus. In this regard, the explanatory instruction to paragraph (a) of Rule 430A provides that a decrease in the volume of securities offered or a change in the price range from the Marketing Prospectus may be disclosed in the Rule 424(b) Prospectus "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." The instruction also provides that any change in volume and any deviation from the low or high end of the price range may be reflected in the Rule 424(b) Prospectus if, in the aggregate, the changes in volume and price represent "no more than a 20% change in the maximum aggregate offering price set forth in the "Calculation of Registration Fee" table in the effective registration statement."

As a result of this instruction, changes in price and offering size that do not exceed the 20 percent threshold are retroactively included in the registration statement via the filing of the Rule 424(b) Prospectus after the effectiveness of the registration statement and will be deemed to be part of the registration statement at the time it became effective for purposes of satisfying Section 11. The flexibility under Rule 430A is extraordinarily useful, as an issuer otherwise would be required to reflect the pricing changes in a post-effective amendment and would need the SEC staff to declare the amendment effective.

SEC staff guidance contained in Securities Act Rules Compliance and Disclosure Interpretation (C&DI) 227.03 provides further flexibility and even circumscribes the materiality determination in the Instruction to Rule 430A(a) in certain cases. The C&DI provides that the Rule 424(b) Prospectus may include the pricing terms if these terms do not exceed the 20 percent threshold set forth in the Instruction to Rule 430A(a) "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." The C&DI goes on to say that even where the ultimate pricing terms exceed this 20 percent threshold, a post-effective amendment is required only if such ultimate pricing terms actually result in material changes to the disclosure set forth in the registration statement at the effective date.[7] For example, if an IPO includes primary and secondary shares and the secondary component of the IPO is the source of the downsizing or upsizing of the IPO in excess of the 20 percent threshold, the change in the size of the offering may not be deemed material.

Factors to consider in the materiality determination include:

- size of the public "float" after the offering;
- use of proceeds;
- pro forma number of shares outstanding; and
- pro forma earnings per share.

In this scenario, the amount and use of proceeds to be received by the issuer, the pro forma number of shares outstanding and the pro forma earnings per share are not affected by a change in the size of the secondary offering.

C&DI Alternative to Rule 430A

The maximum aggregate offering price included in the fee table on the cover page of the registration statement is often not the same as the offering terms disclosed on the cover page of the Marketing Prospectus. This is because the fee table is completed in connection with the initial filing of the registration statement, while the price range and number of shares to be offered are typically not determined and disclosed until the Marketing Prospectus is prepared, which may be months later. Since the ability to upsize or downsize an offering by 20 percent pursuant to Rule 430A is based on the maximum aggregate offering price reflected in the fee table, the SEC staff has provided helpful alternative guidance for calculating the 20 percent threshold that an issuer may rely on when the offering terms of the Marketing Prospectus differ from the fee table.

> Securities Act Rules C&DI 627.01 states that:
>
> [t]he *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 is particularly useful when downsizing because it allows the issuer to calculate the size of the 20 percent threshold using the *high end of the range* in the Marketing Prospectus rather than the fixed maximum aggregate offering price included in the fee table.

For example, consider an issuer that files a registration statement with a $100 million maximum aggregate offering price in the fee table. The issuer's Marketing Prospectus has a price range of $9 to $11 per share and includes 10 million shares to be sold. Pursuant to Rule 430A, this offering could be downsized to $80 million and still fall within the safe harbor of Rule 430A based on the 20 percent calculated from the proposed maximum aggregate offering price included in the fee table ($100 million). Under C&DI 627.01, however, the 20 percent threshold is calculated using the high end of the range ($110 million), which is equal to $22 million. In the case of a downsize, the $22 million may be measured from the low end ($90 million) of the range, which allows the offering to be downsized to $68 million. While C&DI 627.01 may also be used in upsizing an offering, it generally will not provide any benefit not offered by the plain language of Rule 430A, given that the fee table on the cover page of the registration statement typically will reflect a maximum aggregate offering price that is at least as large as that included in the Marketing Prospectus. Further, it is important to note that the flexibility offered by the C&DIs to Rule 430A does not obviate the need to register any additional number of shares or the additional dollar amount of securities to be sold in the IPO in accordance with Rule 413 and Rule 462 under the Securities Act, as explained in "Filing a New Registration Statement for Additional Shares and Upsized Offerings" below.

Payment of Additional Registration Fees for an Upsized Offering

In connection with the initial filing of the registration statement, an IPO issuer typically elects to calculate the registration fee pursuant to Rule 457(o). In doing so, the issuer discloses only the proposed maximum aggregate offering price and avoids alerting the market to the expected price per share at the time of such filing, which would be the case if the issuer were to calculate the fee pursuant to Rule 457(a). If the issuer later amends the registration statement to include a bona fide estimate of the

price range and the number of shares to be offered, the issuer may either (i) rely on the originally filed fee table disclosing only the proposed maximum aggregate offering price pursuant to Rule 457(o), or (ii) include a new fee table prepared in accordance with Rule 457(a) using the per share price and number of shares reflected in the Marketing Prospectus.

If the issuer chooses to include a new fee table prepared in accordance with Rule 457(a), additional filing fees will not be required even if the offering *price* per share later increases. Some issuers will choose to do so because increasing the price per share at pricing is a common scenario in an upsizing. However, if the *number* of shares to be offered is subsequently increased, the issuer will need to register the additional shares and pay the related filing fees. This is true even if the ultimate maximum aggregate offering price, *i.e.,* the new number of shares multiplied by the price per share included in the revised fee table, does not exceed the proposed maximum aggregate offering price. The additional shares will need to be registered by filing a new registration statement. See "Filing a New Registration Statement for Additional Shares and Upsized Offerings."

Alternatively, if the issuer chooses to rely on the fee table prepared in accordance with Rule 457(o), a new registration statement and additional filing fees will not be required so long as the ultimate number of shares sold multiplied by the offering price per share does not exceed the original proposed maximum aggregate offering price.[8] However, if the issuer later increases the price per share, additional filing fees would be required if the number of shares being offered multiplied by the price per share exceeds the proposed maximum aggregate offering price.

Filing a New Registration Statement for Additional Shares and Upsized Offerings

Rule 413 prevents IPO issuers from adding additional securities to the registration statement after effectiveness. As such, to register *any* additional shares (if the issuer is relying on Rule 457(a)) or increase the offering size (if the issuer is relying on Rule 457(o)) after the original registration statement has been declared effective, the issuer must file a new registration statement. If the additional number of shares (under Rule 457(a)) or the additional dollar amount of securities (under Rule 457(o)) does not exceed 20 percent of the maximum aggregate offering price set forth in the fee table at effectiveness, the issuer may file a new registration statement that would become immediately effective upon filing pursuant to Rule 462(b).[9] However, if the 20 percent threshold is exceeded, the issuer instead would be required to file a new registration statement utilizing Rule 429 and wait for the SEC Staff to declare the new registration statement effective.

In either case, a new legal opinion on the validity of the additional number of shares or dollar amount of securities being registered and an additional auditor's consent may need to accompany the new registration statement. An issuer should also consider whether additional board approval and signatures to the registration statement will be necessary.

Rule 462(b) Registration Statement

An issuer is eligible to file an automatically effective Rule 462(b) registration statement if the new registration statement (i) is filed prior to the time confirmations are sent, and (ii) registers additional securities in an amount and at a price that together represent no more than 20 percent of the maximum aggregate offering price set forth in the fee table at effectiveness. Note that even though Rule 462(b) refers to "registering additional securities," it can also be applied where there is an increase in transaction size in a Rule 457(o) offering.[10]

The determination of the 20 percent threshold under Rule 462(b) may differ depending on whether the issuer calculated its fee table using Rule 457(a) or Rule 457(o). If Rule 457(a) was used, the issuer must consider whether the additional shares increase the offering size by more than 20 percent of the offering size in the fee table at effectiveness. This is done by multiplying the number of *additional shares* by the new per share offering price and comparing it to 20 percent of the proposed maximum aggregate offering size in the fee table at effectiveness.[11] Alternatively, if the issuer continues to rely on Rule 457(o), the issuer looks to see if the *total offering size* has increased by more than 20 percent of the

proposed maximum aggregate offering size in the fee table at effectiveness, determined by multiplying *all* of the shares being offered (including the additional shares) by the new price per share.[12]

For example, consider an issuer that calculated its fee table at effectiveness using Rule 457(a), reflecting 10 million shares to be sold at a bona fide proposed maximum price per share of $10 for a maximum aggregate offering price of $100 million. At pricing, the issuer decides to sell an additional 1 million shares and the price per share is increased to $11 per share. To determine Rule 462(b) eligibility, the issuer must look at the value of the additional shares, which is $11 million (additional 1 million shares multiplied by the new $11 per share price). Since $11 million is less than 20 percent of the previous maximum aggregate offering price of $100 million, the upsize falls within the Rule 462(b) threshold. Alternatively, to determine Rule 462(b) eligibility where the issuer had instead calculated its fee table at effectiveness using Rule 457(o), the issuer must look at the total value of the upsized offering, which is $121 million (11 million shares to be sold at the new $11 per share price). Since the increase to $121 million is more than 20 percent of the previous maximum aggregate offering price of $100 million, Rule 462(b) would not be available, and the issuer would need to file a new registration statement, as discussed below.

New Registration Statement

If the additional number of shares (under Rule 457(a)) or the additional dollar amount of securities (under Rule 457(o)) proposed to be registered exceeds the 20 percent threshold of Rule 462(b), the issuer will need to file a new registration statement and wait for the SEC to review and declare the new registration statement effective before confirming orders. The new registration statement would need to include a form of combined prospectus relating to both the offering of the original shares and the additional number of shares to be offered in the IPO.

Rule 159, FWPs and Section 12 Liability

As discussed above, Rule 430A permits certain *material changes to the disclosure* included in the Marketing Prospectus to be included in the Rule 424(b) Prospectus rather than an amendment to the registration statement. Since the pricing information covered by Rule 430A that is included in the Rule 424(b) Prospectus is deemed to relate back to the time of effectiveness, the registration statement meets the Section 11 requirement that all material information be included in the registration statement at the time of effectiveness. However, liability under Section 12(a)(2) of the Securities Act is not limited to the contents of the registration statement.[13] Rather, Section 12(a)(2) takes into account the total package of information disclosed to investors, orally and in writing, *at the time the underwriters confirm orders*. Further, Section 12 liability is based on the contents of the Marketing Prospectus, taken together with any additional information conveyed to investors, orally or in writing, by or before pricing. Therefore, issuers need to ensure that the package of information provided to investors satisfies their obligations under Section 12(a)(2).

Rule 159, adopted as part of the 2005 securities offering reform, provides that pricing information included in the Rule 424(b) Prospectus that is filed after pricing is not considered for purposes of Section 12 liability. Therefore, the material pricing changes that Rule 430A allows to be retroactively deemed part of the registration statement for purposes of Section 11 liability must be communicated to prospective investors prior to confirming orders for Section 12 liability purposes.

Typically, the ultimate pricing terms of an IPO are conveyed orally. This may still be the case even if the offering has been upsized or downsized. If the upsizing or downsizing of an offering only triggers changes to disclosure in the Marketing Prospectus that are easily derivable or calculable by the investor, then the final pricing terms and any changes that flow directly from such final pricing terms (*e.g.*, the total number of shares outstanding after the IPO and the adjusted capitalization of the company) may be conveyed orally. Less obvious changes may need to be reflected in a free writing prospectus (FWP) that is provided to prospective investors as contemplated by Rule 433.[14] For example, a downsizing of the offering may change the use of proceeds and also the pro forma financial information included in the Marketing Prospectus.

Key disclosures that may be affected by upsizing or downsizing the IPO include:

- the use of proceeds;
- pro forma financial information included in the Marketing Prospectus, if any;
- capitalization;
- board composition;
- whether the issuer may avail itself of the controlled company exceptions with respect to the corporate governance rules of the proposed listing exchange;
- the relative beneficial ownership by members of senior management or other significant stockholders; and
- dilution to the IPO investors.

If the upsizing or downsizing of the offering and related pricing changes are so significant that the Marketing Prospectus requires substantial revision, consideration should be given to recirculating a revised Marketing Prospectus in order to satisfy Rule 15c2-8(b) of the Securities Exchange Act of 1934. 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." The introduction of the FWP concept in the 2005 securities offering reform has significantly reduced the number of situations in which a revised Marketing Prospectus needs to be recirculated. A recirculation may still be required where the issuer has made such changes to the original Marketing Prospectus that it can no longer be deemed to be the "preliminary prospectus" within the meaning of Rule 15c2-8(b).

If the issuer determines that Rule 15c2-8(b) requires the recirculation of a revised Marketing Prospectus, the 48-hour requirement discussed above will apply. Although the 48-hour requirement does not apply where the issuer determines it only needs to send investors a FWP to convey the revised disclosure, the issuer and underwriters should ensure that prospective investors have sufficient time to consider the revised disclosure so that the issuer comfortably can satisfy Section 12(a)(2). As the SEC has not provided formal guidance on how much time is deemed sufficient, the working group will need to agree on an appropriate time based on the facts and circumstances of the offering.

Follow-On Public Offerings

Issuers and their advisors would need to address the same issues discussed in this alert for any public offering conducted after an issuer's IPO that is not registered on a Form S-3 or F-3 "shelf" registration statement. For public offerings conducted as a shelf takedown on a Form S-3 or F-3, similar materiality concerns arise but the upsize and downsize percentage limitations related to Rule 430A compliance do not apply.[15]

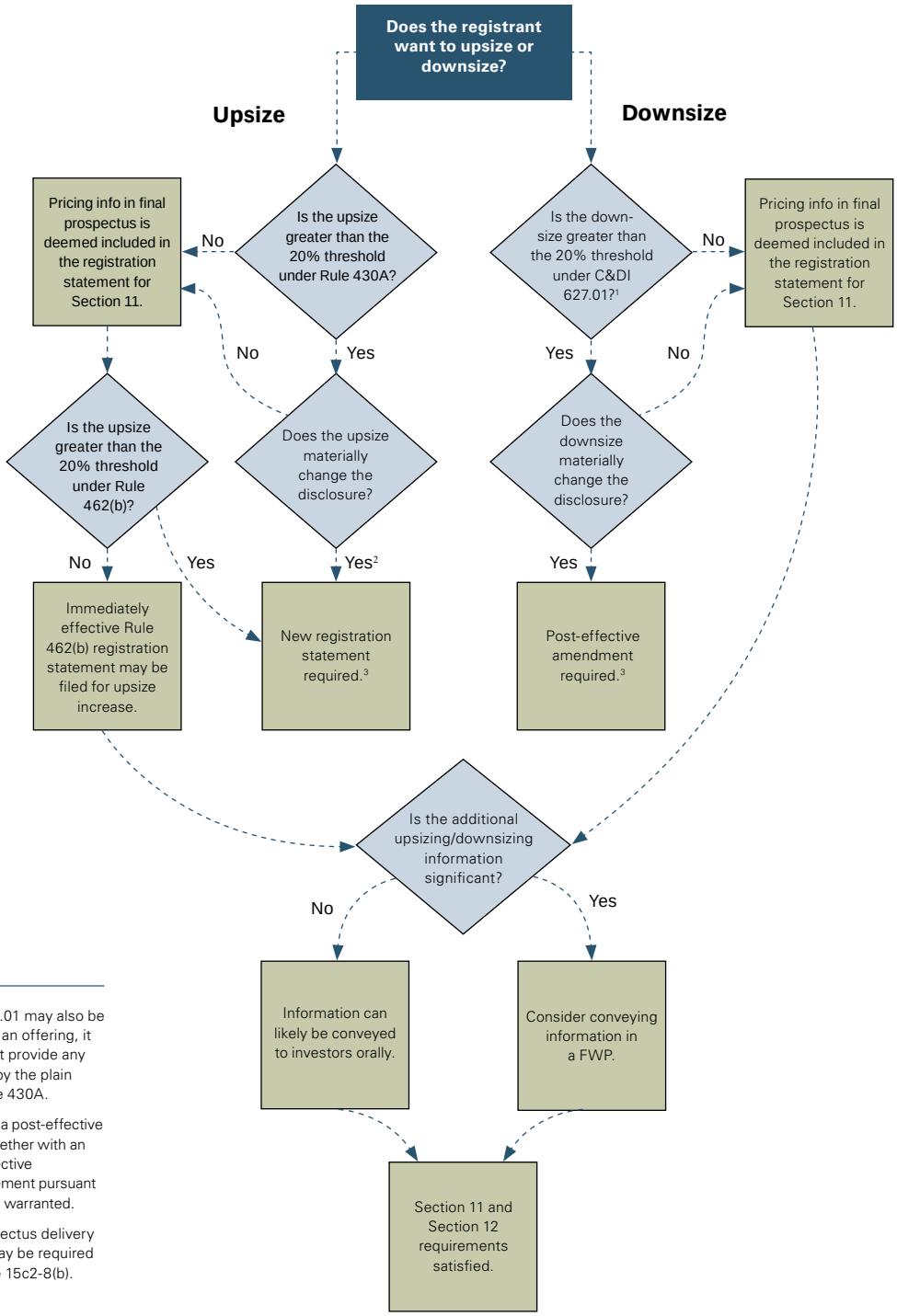
FINRA Considerations

FINRA Rule 5121 applies to public offerings in which a participating FINRA member is deemed to have a "conflict of interest." Pursuant to this rule, a conflict of interest exists if 5 percent or more of the net proceeds of the offering will be directed to a participating FINRA member, its affiliates or other "related persons." If such a conflict of interest exists, the participation of a "qualified independent underwriter" (*i.e.*, an underwriter without such a conflict of interest) would be required to comply with Rule 5121. Also, a description of the circumstances giving rise to this conflict would need to be disclosed in the prospectus. A typical "conflict of interest" under Rule 5121 is the repayment of indebtedness to a lender that is a related person of one of the IPO underwriters. A downsizing of the offering may trigger the application of Rule 5121 if the reduction in the total amount of proceeds causes the amount of proceeds directed to the underwriter-related lender to exceed the 5 percent threshold under this rule.

An issuer should also note the increase of the FINRA filing fee for upsized offerings. The FINRA fee, equal to .01 percent of the total offering amount plus $500 up to a maximum of $75,500, would rise with an upsized offering — necessitating an additional payment by the issuer.

Decision Making Process in Changing Offering Size

The flowchart below depicts the step-by-step decision tree in upsizing or downsizing an IPO.



[1] While C&DI 627.01 may also be used in upsizing an offering, it generally will not provide any benefit offered by the plain language of Rule 430A.

[2] In certain cases, a post-effective amendment, together with an immediately effective registration statement pursuant to Rule 462(b), is warranted.

[3] Additional prospectus delivery requirements may be required pursuant to Rule 15c2-8(b).

Conclusion

In deciding whether to upsize or downsize an IPO, many issues need to be considered, which require a thorough, and sometimes complex, analysis of the offering and the desired last-minute changes in size or price. In many cases, careful advance planning can help ensure that the process of upsizing or downsizing the offering is smooth and free from unnecessary limitations or surprises.

END NOTES

1 During the IPO "road show," this prospectus (also known as the "red herring") is used by the underwriters in marketing the IPO.

2 Regulation S-K 501(b)(3).

3 The number of shares to be sold is also typically subject to a 15 percent over-allotment option. These additional shares are taken into account when calculating the amount by which an offering may be upsized or downsized.

4 The filing fees required to be paid by issuers for the registration of an offering of securities, set at $114.60 per $1,000,000 as of the date of this memorandum, is adjusted from time to time by the SEC.

5 For example, if investor demand is much weaker than anticipated and the underwriters are aware, prior to the requested time of effectiveness, that they will only be able to sell a fraction of the number of shares proposed to be sold and reflected in the Marketing Prospectus, such information may be material to prospective investors, as the market for the issuer's shares may not be as liquid due to the significantly smaller public float. In addition, if the ultimate offering price is well outside the price range set forth in the Marketing Prospectus and the issuer only includes the ultimate price in the final prospectus, the form of the prospectus included in the registration statement at the effective time may not comply with Item 501(b)(3) of Regulation S-K, which requires an IPO issuer to include a "bona fide estimate" of the price range in the Marketing Prospectus.

6 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."

7 Regardless of the size of the increase, a new registration statement must be filed to register any additional securities that are offered, which may be an immediately effective registration statement under Rule 462(b) if the requirements are met. See "Filing a New Registration Statement for Additional Shares and Upsized Offerings."

8 See Securities Act Rules C&DI 640.05.

9 Rule 462 provides for the immediate effectiveness of certain registration statements and certain post-effective amendments.

10 See Securities Act Rules C&DI 640.04.

11 See Securities Act Rules C&DI 640.03.

12 See Securities Act Rules C&DI 640.04.

13 Section 12(a)(2) 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 light of the circumstances under which they were made, not misleading."

14 As a general rule, the FWP may include information "the substance of which is not included in the registration statement." However, this information must not conflict with information contained in the filed registration statement. The FWP rules require that an IPO issuer's FWP be accompanied or preceded by the most recent preliminary prospectus on file with the SEC unless the most recent preliminary prospectus has already been provided and there has been no material change from the prior preliminary prospectus. This requirement may be satisfied where the FWP is an electronic communication containing an active hyperlink to such most recent prospectus.

15 See Rule 430B.

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