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Underwriters, IPOs And Potential FINRA Problems

Law360, New York (August 03, 2010) -- In the past decade, it has become increasingly common for investment banks to have venture capital, private equity or other investment affiliates that invest in private companies for their own account. As a result, in initial public offerings it has been increasingly common for an affiliate of an underwriter to be a stockholder of the issuer, or even to be a selling stockholder in the offering.

This situation can present issues under rules 5110 (Corporate Financing Rule — Underwriting Terms and Arrangements) and 2720 (Public Offerings of Securities with Conflicts of Interest) of the Financial Industry Regulatory Authority, which govern the terms of a FINRA member's participation in certain public offerings.

Counsel facing these situations should consider the following questions in developing an appropriate compliance strategy:

Are there shares owned by a participating member or any related person of an underwriter?

The Corporate Financing Rule requires, among other things, that an underwriter participating in a public offering report the amount of compensation it and its related persons will receive in the offering. The definition of underwriter and related persons is defined broadly to include a FINRA member participating in the offering and its affiliates, among others.

If an affiliate of an underwriter owns securities of the issuer, those securities will be attributed to the underwriter for purposes of FINRA Rules 5110 and 2720.

Are the shares owned by the underwriter or related person underwriting compensation?

Pursuant to Rule 5110(c)(2), all items of value received or to be received from any source by the underwriter and related persons that are deemed to be in connection with or related to the distribution of the offering are underwriting compensation.

Items of value explicitly include equity securities (or securities convertible into or exercisable for equity securities) received as an investment in a private placement made by the issuer, as well as equity securities received for other services or at the time of the public offering.

Though shares of the issuer held by the underwriter or its affiliates are clearly items of value, items of value received and arrangements entered into for future receipt of an item of value more than 180 days before the required filing date of the registration statement are not considered underwriting compensation.

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Therefore, shares owned by an affiliate of an underwriter will not be considered underwriting compensation if the private placement occurred more than 180 days prior to the required filing date of the registration statement.

If the shares or other equity securities have been received (or arrangements to receive them have been made) during the period commencing 180 days prior to required filing date of the registration statement and ending on the effective date of the registration statement (the preoffering compensation period), these shares will be considered underwriting compensation, unless they have been received in certain defined circumstances.

Certain acquisitions of an issuer's shares by an underwriter or related person are deemed not to be underwriting compensation, even though they occur during the preoffering compensation period. These exceptions include a number of situations in which an underwriter or related person may acquire securities of an issuer in a private placement, as compensation for a loan or credit facility or in certain pro rata offerings or distributions of the issuer, as long as the receipt of the shares occurs before the required filing date of a public offering and the private placement, loan or other acquisition meets certain criteria relating to the nature of the investors or lenders and the terms of the transaction.

According to Section C of the NASD (now FINRA) Notice to Members 04-13 (February 2004), the exceptions set forth in Rule 2710(d)(5) (now Rule 5110(d)(5)) "are intended to cover identified bona fide capital-raising transactions." However, even if shares received are not deemed to be underwriting compensation pursuant to these exemptions, the shares are subject to the Corporate Financing Rule's lockup provision, as discussed below.

While most of the Rule 5110(d)(5) exceptions address bona fide capital raising transactions, Rule 5110(d)(5)(D) also exempts from the definition of underwriting compensation securities acquired pursuant to preemptive rights, in a stock split or upon conversion of other securities that are not deemed to be underwriting compensation.

This provision suggests that FINRA views shares acquired in a stock split or on conversion of preferred shares to be a new receipt of shares as of the date of the stock split or conversion, even if they are received solely in respect of shares already owned by the underwriter or related person, with no new consideration paid or services provided to the issuer.

It is therefore very important to analyze carefully all new shares received by an underwriter or related person, even if they are received pursuant to or in respect of shares owned prior to the preoffering compensation period. While shares issued in a stock split or on conversion of preferred shares are not underwriting compensation if they meet the requirements of Rule 5110(d)(5)(D), such shares may be subject to the lockup restrictions described below.

If securities owned by an underwriter or related person are deemed to be underwriting compensation, the value of the shares must be disclosed to FINRA and will be taken into account in FINRA's determination as to whether the underwriting compensation is unfair or unreasonable. The Corporate Financing Rule includes guidance as to how to value noncash compensation, including securities.

Are the shares owned by an underwriter or related person subject to the lockup provisions of Rule 5110?

The Corporate Financing Rule includes a lockup restriction, which generally restricts underwriters and related persons from selling shares acquired in the preoffering compensation period in the offering or in the 180 days following the offering.

Therefore, if an underwriter or related person is interested in selling shares in the offering, it is important to evaluate whether all or any number of the shares proposed to be offered are subject to the lockup.

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Such shares are subject to the lockup provision if they are acquired in the 180 days prior to the required filing date or acquired after the required filing date and deemed to be underwriting compensation by FINRA. Securities that are excluded from underwriting compensation pursuant to Rule 5110(d)(5) are also subject to the lockup provision, as discussed above. There are some exceptions to the lockup restrictions, including if the aggregate amount of securities of the issuer owned by the underwriter and related persons, in the aggregate, does not exceed 1% of the securities being offered in the offering.

As a result of the provisions of Rule 5110(d)(5)(D) and 5110(g), shares received by an underwriter or related person pursuant to a stock split or conversion of preferred stock are subject to the lockup restrictions of Rule 5110(g), unless one of the limited exceptions to the lockup restrictions apply. This situation may arise frequently in IPOs, as it is very common for issuers to adjust their capitalization structure in advance of their IPO.

Many companies effect stock splits in advance of an IPO. The preferred stock of most venture capital backed companies converts automatically into common stock by its terms upon an IPO. These rules, therefore, could prevent an underwriter or related person from selling some or all of their shares in the offering, even if the underwriter or related person made its investment in the issuer long before the preoffering compensation period.

FINRA has published one letter granting exemptive relief from the lockup restrictions for shares issued in a pre-IPO stock split.

Will the receipt of proceeds by a selling stockholder that is affiliated with an underwriter create a conflict of interest?

If an aggregate of 5 percent or more of the net offering proceeds, not including underwriting compensation, are to be directed at an underwriter, its affiliates or associates, then that underwriter is deemed to have a conflict of interest and the offering must be conducted in accordance with Rule 2720.

Proceeds received by a selling stockholder that is an underwriter or related person must be considered in determining whether a conflict of interest exists. If an offering becomes subject to Rule 2720, then a qualified independent underwriter must be appointed unless (i) the member(s) primarily responsible for managing the offering (including all bookrunners) do not have a conflict of interest, or (ii) the securities have a bona fide public market or are rated be investment grade.

In addition, the conflict of interest must be prominently disclosed in the prospectus, in the manner prescribed by Rule 2720(a). Furthermore, no FINRA member that has a conflict of interest may sell to a discretionary account any security with respect to which a conflict exists, unless the member has received written approval of the transaction from the account holder.

Conclusion

Underwriters' counsel in IPOs and other offerings should consider early in the process whether any of the underwriters or their affiliates or other related persons are investors and/ or potential selling stockholders in the offering, because resolving these issues can take time.

If an underwriter or related person owns shares of an issuer that are deemed to be underwriting compensation, such ownership may complicate or lengthen the FINRA clearance process for the offering. If an underwriter or related person owns shares of the issuer that are subject to the lockup restrictions, they may have to abandon any plans for sale of those shares in the offering, or consider whether they can appropriately request exemptive relief from FINRA.

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Furthermore, if a sale of shares by an underwriter or related person triggers application of the conflict of interest rules, the issuer and underwriters will need to take steps to comply with the conflict of interest rules, including designating an underwriter as the qualified independent underwriter, if no other exemption is available.

Failure to address these issues early could result in a delay in FINRA clearance or otherwise affect the smooth progress of the offering.

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