



Issuer-Directed Shares and Related FINRA Issues

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What is FINRA and why does it matter?

- What is FINRA?
 - Financial Industry Regulatory Authority regulates underwriters and underwriting terms or arrangements (cannot be unfair or unreasonable)
- Why does FINRA matter?
 - IPOs cannot proceed until FINRA confirms it has “no objections” to the underwriting arrangements
 - Provides guidelines for permitted allocations and places restrictions on types of allocations of shares in the offering
 - Compliance work managed by underwriters’ counsel, but typically issuer pays for the associated FINRA filing and legal fees
 - Gathering information from securityholders for FINRA submission can be tedious and time consuming depending on numbers involved



Issuer-directed shares

- An issuer can affect the allocation of shares by one of three methods:
 - Concurrent private placement: exempt offering of securities that occurs simultaneously with registered offering
 - Allocation without disclosure: amount of shares allocated and/or identities of purchasers are not specifically disclosed due to immateriality
 - Allocation with disclosure
 - ▶ DSPs / “friends and family” allocation
 - ▶ Indication of interest from potential purchaser(s)



Issuer-directed shares (cont'd)

- Directed Share Programs (DSPs)
 - Underwriter sets aside certain number of shares
 - Made available to “friends and family,” employees, suppliers or others designated by the issuer
 - ▶ Typically no more than 5% of offered shares
 - Cannot be made available to FINRA “associates” or immediate family of FINRA “associate”
 - ▶ Goal: avoid preferential allocations to investment professionals
 - Any lock-up agreement that covers shares owned by an officer or director must also cover officer or director shares acquired pursuant to a DSP
- Potential disadvantages
 - Added cost, complexity and risk
 - Demand / proceeds may not justify cost
 - Negative implications if offering is not as successful as anticipated



Related FINRA allocation rules

- Rule 5130 prohibits underwriters from selling new issues to accounts in which a “restricted person” (e.g., FINRA member, associated persons of FINRA member, including immediate family members) has a beneficial interest
 - Exception if issuer specifically directs shares, but shares may not be sold to:
 - ▶ A broker-dealer
 - ▶ An account in which finders, fiduciaries and portfolio managers have a beneficial interest, unless such person (or member of immediate family) is an employee or director of issuer
 - Must obtain a representation letter within last year that an account is eligible to purchase in compliance with this rule
- Rule 5131 addresses certain perceived underwriting abuses during dot-com era, including spinning (allocation of “hot” IPOs to directors/officers of potential investment banking clients)
 - Anti-spinning rule prohibits underwriter from allocating shares of a new issue to these covered persons
 - But, prohibition will not apply if issuer directs underwriter in writing to allocate shares to such persons



Underwriter compensation arrangements

- Maximum amount of underwriting compensation considered fair and reasonable depends on risk assumed by underwriters and amount of offering gross proceeds
- All “items of value” received or to be received that are deemed in connection with or related to the offering are included
 - Underwriters’ discount: typically 7% of gross proceeds for an IPO
 - Underwriters’ counsel fees for FINRA matters
 - Deemed to be in connection if received within 180 days before first SEC filing and 90 days after the offering
- Other less intuitive “items of value”, e.g., purchase of issuer securities by underwriter’s asset management affiliate even if for fair market value
- May require restructuring underwriter compensation, other arrangements or syndicate



Conflicts of interest and qualified independent underwriters

- “Conflicts of interest” include:
 - Issuer is controlled by a FINRA member
 - If >5% of the net proceeds used to pay off debt owed to a FINRA member or its affiliates
- Qualified Independent Underwriter (QIU): if underwriter deemed to have a conflict of interest with the issuer
 - Not required if managing underwriter does not have a conflict of interest
 - QIU participates in syndicate and must:
 - ▶ Participate in the preparation of the registration statement and prospectus
 - ▶ Exercise the usual standard of due diligence
 - Accompanied by disclosure in the prospectus regarding the nature of the conflict, name of FINRA member acting as QIU and a description of QIU’s role and responsibilities
 - Additional indemnification obligations



Practical implications of FINRA compliance

- Costs – Issuers typically pay
 - Underwriter counsel’s fees related to FINRA (up to a cap)
 - FINRA filing fees (\$500 plus 0.15% of proposed maximum offering price but no more than \$225,000)
- Timeline
 - Within 1 day of each SEC submission (includes confidential submissions)
 - Prior to filing, gather information
- Effort
 - Collecting questionnaires from officers, directors, employees and shareholders can be time-consuming and tedious
 - Start early and coordinate closely with issuer’s counsel



Key takeaways

- Consult with counsel regarding FINRA matters early in the offering process
 - Notify counsel if there are any preexisting relationships involving underwriters
- Structure ***fair*** and ***reasonable*** compensation arrangements with underwriters
- Discuss possibility of issuer-directed shares with syndicate and counsel early in the offering process



Thank you!

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