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Public Offerings by Securities Exchanges, Alternative Trading Systems, and Broker-Dealers

While the recent market turmoil has constrained the launch of securities offerings, record trading volumes continue to make for a solid pipeline of offerings by securities exchanges, alternative trading systems, and broker-dealers. These offerings often raise complex legal issues. These financial institutions and their advisers should take particular care in structuring these offerings to address these often subtle issues.

by James H. Ball, Jr., and Jihay Ellie Kwack

The last five years or so has seen a wave of demutualizations by securities exchanges and public offerings by these and other financial institutions, including alternative trading systems and broker-dealers. Notwithstanding the recent turmoil in the marketplace, there are many more such offerings in the pipeline. These demutualizations and offerings have been driven by a host of factors, including international and domestic

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competition, changes in the regulatory regime and record trading volumes. Public offerings by these financial institutions often give rise to particular legal issues such as regulation by the Financial Industry Regulatory Authority (the successor to the NASD), or FINRA, unique contractual lock-up arrangements, concerns surrounding the issuer acting as an underwriter and additional review by the Securities and Exchange Commission (SEC).

Offers to Broker-Dealers with Preexisting Relationships with the Issuer

NASD Conduct Rule 2790 prohibits sales of securities in a public offering to certain “restricted persons,” including registered broker-dealers and their affiliates. However, securities exchanges, alternative trading systems, and broker-dealers considering an offering often have preexisting relationships with investors, participants, customers, or others who are broker-dealers or other “restricted persons” who may wish to participate in the offering. One method that issuers often use to sell to these “restricted persons” is to offer securities through a directed share program¹ and to seek an exemption from FINRA for sales to broker-dealers or other “restricted persons” who are included in the directed share program. Pursuant to Rule 2790(h), the FINRA staff may conditionally or unconditionally exempt any person, security, or transaction from Rule 2790 to the extent such exemption is consistent with the purposes of the rule, the protection of investors, and the public interest.²

For instance, prior to their initial public offerings, securities exchanges typically are owned by members or have member firms that are registered broker-dealers or other “restricted persons.” While Rule 2790(d)(1) provides a general exemption for new issue securities that are specifically directed by the issuer to “restricted persons,” this exemption does not apply to securities directed to exchange members who are broker-dealers. FINRA frequently grants an exemption from Rule 2790 for the sale of equity securities through the directed share program to exchange members when such exchange members are deemed essential to the exchange’s operations and when such sale would not be contrary to the protection of investors and the public interest. Some exchange members previously may have owned equity in the exchange prior to a public offering and other exchange members who previously did not own equity may want to become equity holders to avoid dilution in the offering. In cases like these, FINRA generally has justified including the exchange members who previously did not own equity and who are essential to the exchange’s operations in the directed share program to place them on an equal footing with other exchange members that own equity. In granting the exemption, FINRA has noted that such exchange members would not be involved in the distribution and would be subject to a 180-day contractual lock-up.

Offers to Institutions with Preexisting Relationships with the Issuer

A different concern involving Rule 2790 may arise when an issuer has preexisting relationships with institutions (non-broker-dealers such as pension funds) that typically participate in public offerings and wishes to direct the underwriters to sell only to such institutions or to prioritize sales to such institutions. For instance, an alternative trading system may wish to restrict the institutional portion of its initial public offering to institutions that trade on its system. Concerns may arise that such restrictions could fail to make the offer a “bona fide public offering” as required under Rule 2790. Rule 2790 is designed to ensure that (1) FINRA members, including registered broker-dealers, make a bona fide public offering; (2) FINRA members do not withhold securities for their own benefit or use such securities to

reward persons who are in a position to direct future business to FINRA members; and (3) industry insiders, including FINRA members and their associated persons, do not take advantage of their insider position to purchase “new issues” for their own benefit at the expense of public customers.

Whether an issuer has made a bona fide public offering is determined on the basis of all relevant facts and circumstances. There is no *per se* requirement to provide equal opportunity to various institutions to participate in the offering. In fact, Rule 2790 was adopted partly because underwriters have discretion in allocating shares to institutions. Issuers often work with underwriters to determine the makeup of the accounts to which the shares are allocated, such as what percentage should go to long-term investors versus hedge funds and other types of investors. Therefore, it should be permissible for an issuer to make sure that the institutions with which it has preexisting relationships get a share of the allocation either within or outside the directed share program. However, it would probably not be permissible for the issuer to request the underwriters to allocate exclusively to these institutions outside the directed share program. It may be advisable for an issuer wishing to allocate a greater part of the offering to institutions with preexisting relationships to confirm with FINRA that offering to such institutions would not violate Rule 2790. For instance, the issuer might convince FINRA that limiting sales to institutions that trade on the issuer’s system would not raise concerns that underwriters may allocate shares for their own benefit or to reward persons that would bring future business to the underwriters. The issuer also might argue that institutions that trade on its system are essential to its operations.

Issuer Participating as Underwriter

Given that most broker-dealer affiliates have a significant amount of securities experience, they often want to participate as an underwriter in a public offering through an existing or newly-formed broker-dealer affiliate. When the issuer or its affiliate participates as an underwriter, the offering becomes subject to NASD Conduct Rule 2720, which provides that a FINRA member with a “conflict of interest” may participate in the distribution

of a public offering only in accordance with Rule 2720. Rule 2720(c)(3) requires that the initial public offering price may be no higher than that recommended by a “qualified independent underwriter,” as defined in Rule 2720(b)(15), and imposes certain other restrictions on the conduct of the offering.³ The qualified independent underwriter must participate in the preparation of the registration statement and the prospectus and exercise the usual standards of “due diligence.”⁴ In addition, if the issuer and/or affiliates are members of a securities exchange, they would also be subject to the conduct rules of the securities exchange.⁵

The quintessential example of this is the initial public offering by Goldman Sachs Group, Inc., in which the issuer was named an underwriter in the US offering, although it did not purchase shares. Goldman, Sachs & Co., a subsidiary of the issuer, and other affiliates of the issuer also participated in the offering as underwriters. The issuer engaged a qualified independent underwriter in accordance with Rule 2720, and furthermore, the affiliated underwriter Goldman, Sachs & Co, was not permitted to make markets or recommendations regarding the purchase or sale of the common stock. These restrictions were disclosed in the registration statement. More recently, Liquidnet Holdings, Inc., an electronic marketplace focusing on trading by institutional investors, filed a registration statement in connection with its contemplated initial public offering, in which its affiliate, Liquidnet, Inc., intends to participate as an underwriter. In accordance with Rule 2720, the issuer plans to engage a qualified independent underwriter.

Contractual Lock-Ups

Another interesting aspect of these types of offerings is the unusual contractual lock-up arrangements in offerings by securities exchanges. As a rule of thumb, underwriters typically impose a 180-day contractual lock-up in the case of initial public offerings and a shorter lock-up in the case of follow-on or secondary offerings. However, there often are longer lock-up periods or other unusual types of lock-ups. One reason for these unique lock-ups is that while private companies in general have only a handful of private investors before becoming a public company,

securities exchanges were historically not-for-profit membership corporations with numerous members before they became public. Therefore, in the case of securities exchanges, if it was to impose a “standard” 180-day contractual lock-up, there potentially could be a greater disruption to the market with millions of shares becoming released at the same time.

In an initial public offering by a securities exchange, while the directors, officers, and stockholders may enter into “standard” 180-day contractual lock-up agreements with the underwriters, existing stockholders also may be parties to a preexisting stockholders’ agreement. The agreement may impose other transfer restrictions, such as prohibiting transfers of common stock without board approval until a number of years from the closing of the initial public offering. In such instance, if the issuer plans a secondary offering shortly after the initial public offering, the board of directors may decide not to grant approvals for transfers of common stock prior to the secondary offering, except for certain *de minimis* transfers under special financial “hardship” circumstances, in order to ensure an orderly distribution of shares in the secondary offering.

Other financial institutions have used a staggered lock-up at the time of their initial public offering, which expires at different intervals following the closing of the offering. In such case, an issuer may issue different series of common stock and include provisions in its certificate of incorporation so that different lock-up restrictions would apply depending on the series of common stock.

Oversight by SEC Division of Trading and Markets

Another important point to keep in mind when securities exchanges make a public offering is that as self-regulatory organizations, the exchanges are subject to the oversight of the SEC’s Division of Trading and Markets, which could have an impact on the timing of the offering. A registration statement for a public offering filed by a securities exchange will be subject to review not only by the Division of Corporation Finance but also, to the extent a rule change of the securities exchange is required as is often the case, by the Division of

Trading and Markets. The comments of the staff of the Division of Trading and Markets may be included in the comment letter from the staff of the Division of Corporation Finance or may be issued separately. Unlike the Division of Corporation Finance, which will limit its comments to making sure there is adequate disclosure, the Division of Trading and Markets often will examine the merits of the offering in an effort to protect the integrity of the public markets.

A securities exchange may need to make “rule changes” in connection with an offering, such as changes to its charter, bylaws, trading rules, initial listing standards or independence policy.⁶ Under SEC’s analog to the Administrative Procedure Act, Section 19(b) of the Securities Exchange Act of 1934, the exchange must provide the opportunity for notice and comment to its rule changes. Logistically, this occurs by submitting an application to the Division of Trading and Markets on Form 19b-4. Often, the application is first submitted confidentially in a draft form, and after discussions with the Division of Trading and Markets, the securities exchange formally files the application, which becomes published on the SEC’s Web site and subsequently in the Federal Register. While some applications become effective upon filing, many others are subject to a 21-day comment period from the date they appear in the Federal Register. In accordance with the internal policy of the SEC, within 35 days of the date of publication of the notice in the Federal Register, or within such longer period (1) as the SEC may designate up to 90 days after such date of publication if it finds such longer period to be appropriate and publishes its reasons for so finding; or (2) as to which the securities exchange consents, the SEC will by order, approve the proposed rule change or institute proceedings to determine whether the proposed

rule change should be disapproved. While recently, the SEC has revised its internal policy to speed up the approval process, parties should keep in mind that they will not be able to close an offering or another type of transaction at least until they obtain approval on the related rule changes.

Conclusion

As discussed above, but by no means limited to these issues, public offerings by securities exchanges, alternative systems, broker-dealers and other financial institutions often involve complex and subtle nuances that do not arise in public offerings by other types of companies. Financial institutions and their advisers should take particular care in structuring these public offerings to not get tripped up by the host of issues that may arise.

NOTES

1. A directed share program is a plan designed to allow issuer’s employees, their relatives and other parties with a relationship to the issuer to purchase shares at the public offering price.
2. Information about such exemptions can be found at http://www.investorwords.com/55111/directed_share_program.html.
3. For example, Rule 2720(d) imposes certain requirements relating to disclosure in the registration statement when the offering is conducted by a FINRA member with a “conflict of interest.”
4. See NASD Conduct Rule 2720(c)(3)(A).
5. For example, members of NYSE Euronext who conduct the offering would be subject to the conduct rules of NYSE Euronext, which may impose additional restrictions on conducting the offering.
6. For example, in an offering by a securities exchange in connection with an acquisition of another securities exchange, both securities exchanges may need to amend their governance documents to reflect the changes in the governance structure following the acquisition. Trading rules of both securities exchanges may also need to be amended to allow the two securities exchanges to operate compatible trading systems.

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