The art of dribbling

Research issues for banks organising equity distribution programmes

Dribbling – the very word has negative connotations. We tend to think of a bad shower in a bad hotel. Yet, in at least one context, dribbling is viewed as a good thing. Equity distribution programmes, often called dribble-out programmes, have become a popular way for issuers to sell small amounts of their equity at various intervals during the life of a programme. Some issuers think of an equity distribution programme as the equity equivalent of a medium-term note programme.

Equity distribution programmes provide a means to issue and sell securities from time to time using a shelf registration statement to, or through, a broker-dealer. The broker-dealer acts either on a principal or agency basis to effect at-the-market offerings of the issuer's securities. An issuer eligible to use a registration statement on Form S-3 on a primary basis may register its securities for sale in at-the-market offerings. Before securities offering reforms, in such a sale an issuer was limited to registering securities not exceeding 10% of its aggregate market value. An issuer may choose to allocate a portion of an unallocated universal or so-called kitchen sink shelf registration statement to at-the-market offerings, or use a shelf registration statement established for this purpose. The registration statement's plan of distribution must describe the general terms of the at-the-market offerings to be conducted and identify the participating broker-dealers.

Before carrying out an equity distribution programme, the investment bank and its counsel will conduct diligence regarding the issuer and its business. The bank and the issuer will enter into a distribution agreement establishing the term of the programme and setting out the terms and conditions on which they will conduct the offerings. A standard distribution agreement generally provides both for principal and for agency transactions. The agreement contains representations, warranties and covenants from the issuer and requires the issuer to deliver legal opinions (including a 10b-5 negative assurance from issuer's counsel) and comfort letters at the outset. The distribution agreement provides for the issuer's representations and warranties to be refreshed at each issuance, and for periodic updates to the issuer's deliveries to the bank. The distribution agreement also contains standard market-out termination provisions.

Whether acting as principal or agent, the investment bank will sell the issuer's securities through market-makers or electronic trading systems at prices related to the volume-weighted average price for the securities. These transactions generally will not involve special selling efforts (such as a road show) and will not involve a large amount of the issuer's securities relative to the issuer's public float or daily trading volume. The commission or spread the issuer pays to the bank is consistent with that payable to a dealer executing trades rather than the spread that would be payable to a broker-dealer acting as an underwriter in connection with a distribution. The investment bank's execution of at-the-market offerings under these programmes more closely resembles ordinary dealer activity than participation as an underwriter in a securities distribution.

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Central to the success of an equity distribution programme is the capability of the investment bank acting as distribution agent. That bank will have to be attentive to restricted lists, research coverage and conflicts. Most investment banks maintain grey or watch lists, and black or restricted lists, which identify securities that might be the subject of investment banking or other corporate finance activity by the institution. The grey list identifies securities that the banking department is active in. Putting a security on the grey list allows the compliance department to monitor the firm's trading, as well as publication of research, or commencement of research coverage, relating to the issuer. Usually, the grey list's content is known only to the compliance and legal groups and is not broadly disseminated. A black or restricted list is broadly distributed within the firm and identifies all those stocks in which trading by the firm as principal and by employees is prohibited or restricted while the security remains on the list.

In connection with the investment bank's participation in equity distribution programmes, the bank should consider whether, once it has entered into a distribution agreement with an issuer, that issuer's securities should be placed on either the grey or black list for the programme term. We suggest that the bank consider placing the issuer's securities on the firm's grey list so the compliance and legal departments can monitor the firm's activities related to that issuer. These departments could then monitor whether the bank may undertake other engagements on the issuer's behalf; whether an engagement might pose a business conflict; whether the bank may begin research coverage, change its research recommendations, or release a new research report; whether the bank has appropriate trading wall procedures in place; and whether the bank can undertake proprietary trading activity in the security.

The investment bank could include the issuer on the firm's black list but, given the long-term nature of an equity distribution programme and the limited nature of the bank's execution activities regarding a programme, this could be limiting and suggestive of more active banking involvement by the bank.

An investment bank serving as a distribution agent in an equity distribution programme also needs to consider how to address research coverage. A bank might participate in a programme for an issuer for

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which it does not provide research coverage. Of course, the bank also might already provide research coverage for the issuer. In either case, questions arise concerning the bank's research activities in light of the services that it provides for the issuer in its distribution agent role. If the bank does not provide research coverage for an issuer for whom it acts as a distribution agent, when may it begin research coverage? If the bank already provides research coverage for the issuer, does it need to monitor timing of new research reports, the recommendations they include, and whether they are published with reasonable regularity?

All of these questions assume that the investment bank's participation as a distribution agent would constitute acting as a distribution participant in connection with the issuance of securities. The SEC has said that having a shelf registration statement in place does not, alone, constitute a distribution but that individual takedowns from the shelf registration statement would constitute distributions. It is not clear whether an issuer with an equity distribution programme would be presumed to be "in distribution" during the term of the programme. This seems unlikely, given that an issuer might have a programme in place for several months and not access it during that time. Without conceding any conclusion on this issue, we have assumed that the bank would choose to conduct its research activities as if it were a distribution participant in respect of equity distribution programmes.

Some questions can be answered by analogy relying on the safe harbour provided by Rule 139 under the Securities Act. Rule 139 permits a broker-dealer participating in a distribution of securities offered by an S-3 eligible issuer to publish research about any issuer or class of securities without the report being considered an offer or a non-conforming prospectus, provided that the research appears in a publication distributed with reasonable regularity in the normal course of the broker-dealer's business. All of the issuers that participate in equity distribution programmes must be eligible to use a registration statement on Form S-3 on a primary basis, so these issuers will meet the conditions set out in Rule 139(a).

If the investment bank already provides research coverage to an issuer for whom it acts as a distribution participant under an equity distribution programme, the bank should monitor its research activities, but rely on the Rule 139 safe harbour. To comply with the safe harbour, the bank will have to monitor that, during the term of the programme: (1) the information, opinion or recommendation is contained in a publication that (a) is distributed with reasonable regularity in the normal course of business and (b) includes similar information with respect to a large number of companies in the issuer's industry or sub-industry or contains a comprehensive list of securities recommended by the broker or dealer; (2) the information, opinion or recommendation is given no greater space or prominence in the publication than that given to other securities or registrants; and (3) an opinion or recommendation as favourable regarding the issuer or any class of its securities was published by the broker or dealer in its last publication addressing the registrant or its securities before participation in the distribution.

If the investment bank is a distribution agent for an issuer's equity distribution programme but does not provide research coverage, a question might arise if the bank chooses to begin research coverage during the term of the programme. Given the continuous nature of a programme, the timing of research coverage is complex. Here less guidance is available but, again, it might be useful to analogize and rely on the regulatory guidance regarding research coverage after a follow-on public offering. An NASD member cannot publish a research report on an issuer for which the issuer acted as a manager or co-manager of a secondary (follow-on) offering for 10 calendar days after the offering date. In this case, the investment bank could institute a policy that it will not begin research coverage or provide a research report for at least 10 calendar days after an equity distribution programme is set up.

The investment bank will probably want to consider guidelines regarding the review process undertaken regarding research on the securities of issuers for which the bank acts as a distribution agent. These should include procedures for handling research reports that include a change in rating, that include projections, and that are issued outside of the regular course of business.

An investment bank should also consider potential conflicts of interest in connection with its role as distribution agent. For example, if the bank were being considered as a financial adviser to render a fairness opinion regarding a transaction involving an issuer for which it acts as a distribution agent, would its activities raise concerns regarding independence? Generally, it is unlikely that the investment bank's activities as a distribution agent would raise any issues regarding its independence in this context. The SEC and court cases considering the independence of financial advisers have focused on the questions raised by payments of success fees in connection with a transaction. A conflict might arise if the bank were being considered as a financial adviser in connection with an issuer's financial restructuring. Here, acting the issuer's distribution agent could raise concerns regarding independence. Other conflict questions might arise during the bank's involvement as a distribution participant in connection with an equity distribution programme. These conflict issues are difficult to anticipate and not amenable to any generalized policy.

For an issuer that seeks the flexibility to control the timing and size of its stock sales, the ability to match its capital raising closely to its capital needs, and the opportunity to sell securities into the regular market flow, whether or not the underwritten public offering window is open, an equity distribution programme, or dribble out, has become an attractive option. Reits, utilities, energy companies and other companies that have continuous financing needs and the desire to engage in balance-sheet management are good candidates for equity distribution programmes. That these programmes have minimal impact on the price of their stocks is particularly important to these companies. For an investment bank that is inclined to act as a distribution agent, it is critical to consider the relevant compliance, regulatory and conflict issues at the outset. Once considered, these issues will rarely prevent participation in a successful programme. So, to an increasing extent, dribbling is proving to be a good thing.

By Anna T Pinedo and James R Tanenbaum of Morrison & Foerster