

October 13, 2010

SEC Approves FINRA Rule Regarding IPO Allocation Practices

On September 29, 2010, the Securities and Exchange Commission (“SEC” or “Commission”) granted “accelerated approval” of the proposed Financial Industry Regulatory Authority (“FINRA”) rule 5131, as modified by Amendment Nos. 1 through 4,¹ regarding allocations and distributions of shares in IPOs (the “Adopted Rule”).² Among other things, the Adopted Rule includes provisions that prohibit the “spinning” of IPO shares to present and prospective investment banking clients.

Regulatory history. The Adopted Rule was first proposed by NASD in 2002 as NASD Rule 2712,³ and was amended and reissued by the NASD in both 2003 and 2004,⁴ and was amended and was designated FINRA Rule 5131 in March 2010. Amendment No. 4 made certain incremental substantive changes (including to the prohibitions on spinning, lock-up agreements, and agreements among underwriters) that responded to commenters’ concerns regarding certain provisions and definitions.

- ¹ NASD amended the proposed rule change on December 9, 2003 and August 4, 2004. On February 10, 2010, FINRA filed with the Commission Amendment No. 3 to SR-NASD-2003-140. The Commission published the proposed rule change, as modified by Amendment No. 3, for comment in the Federal Register on March 18, 2010. The Commission received three comment letters in response to the proposed rule change. On July 30, 2010, FINRA responded to the comment letters and filed Amendment No. 4 to the proposed change.
- ² The Adopted Rule is described in the SEC’s release “Notice of Filing of Amendment No. 4 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment Nos. 1 through 4, Relating to the Prohibition of Certain Abuses in the Allocation and Distribution of Shares in Initial Public Offerings,” SEC Release 34-63010 (September 29, 2010), currently available at: <http://www.sec.gov/rules/sro/nasd/2010/34-63010.pdf> (the “Adopting Release”). For more information, please see Gittleman, C. and Sacks, R., “How plans to curb spinning could wrong-foot banks,” *International Financial Law Review* (January 2004). The Proposed Rule is numbered SR-NASD-2003-140 and can be found on FINRA’s Internet website, www.finra.org.
- ³ See “*NASD Proposes New IPO Allocation and Distribution Rules*” (September 12, 2002), available at http://www.shearman.com/sf_091902/.
- ⁴ See “*NASD Reissues Proposed Rule Governing IPO Allocations and Distributions*” (December 1, 2003), available at http://www.shearman.com/cm_1203_2/.

Effective date. The Adopted Rule becomes effective not less than 90 and not more than 180 days after publication of a FINRA Regulatory Notice, which by the SEC's terms must be published within 60 days.

Summary of Adopted Rule

As revised, the Adopted Rule provides for the following:

- *Spinning:* A prohibition on the allocation of new issue shares to the account of an executive officer or director of a company⁵ (1) that is currently an investment banking client; (2) if in the 12-month period *prior* to the allocation, the broker-dealer received compensation from the company for investment banking services; (3) if the FINRA Member expects to provide or be retained for investment banking services in a three-month period following the allocation; or (4) on the condition that such executive officer or director, on behalf of the company, retain the Member for performance of future investment banking services. The prohibitions do not apply to allocations of issuer-directed shares, so long as the Member has no involvement or influence in such allocation decisions.
- *Quid Pro Quo Allocations:* A prohibition on the offer to allocate, or threat to withhold allocation of, new issues⁶ (which is defined as any initial public offering of an equity . . . security) in exchange for the receipt of compensation that is excessive in relation to the services provided to the customer by the FINRA Member. The assessment of whether or not compensation is "excessive" is based upon all of the relevant facts and circumstances, including, where applicable, the level of risk and effort involved in the transaction and the rates generally charged for such services.

⁵ Amendment No. 4 deleted the definition of "account of an executive officer or director," and instead included a new limitation in the spinning rule providing that the spinning prohibitions would not apply to allocations made to any account described in FINRA "New Issue" Rule 5130(c)(1) through (3) and (5) through (10), or to any other account in which the beneficial interests of executive officers and directors of the company and persons materially supported by such executive officers and directors in the aggregate do not exceed 25% of such account. The New Issue rule prohibits brokers and dealers from selling "new issue securities" to any account in which a restricted person holds a beneficial interest. However, FINRA Rules 5130(c)(1) through (3) and (5) through (10) provide an exemption from for sales to and purchases by the following accounts and persons (1) investment companies, (2) common trust funds, (3) insurance company accounts, (4) publicly traded broker-dealers, (5) foreign investment companies, (6) qualified employee benefit plans, (7) state or municipal government benefit plans, (8) 501(c)(3) charitable organizations, and (9) qualified church plans. For more information about the New Issue Rule, see "*SEC Approves Minor Amendments to FINRA "New Issue" Rule 2790 Relating to IPO Directed Share Programs*" (August 9, 2007), available at <http://www.shearman.com/sec-approves-minor-amendments-to-finra-new-issue-rule-2790-relating-to-ipo-directed-share-programs-08-09-2007/>.

⁶ The term "new issue" has the same definition provided in FINRA Rule 5130(i)(9), and the definition excludes the same offerings excluded under FINRA Rule 5130(i)(9). Under FINRA Rule 5130(i)(9), "new issue" means "any initial public offering of an equity security made pursuant to a registration statement or offering circular." The definition excludes "(A) offerings made pursuant to an exemption under Section 4(1), 4(2) or 4(6) of the Securities Act, or Securities Act Rule 504 if the securities are "restricted securities" under Securities Act Rule 144(a)(3), or Rule 144A or Rule 505 or Rule 506 adopted thereunder; (B) offerings of exempted securities as defined in Section 3(a)(12) of the Exchange Act, and rules promulgated thereunder; (C) offerings of securities of a commodity pool operated by a commodity pool operator as defined under Section 1a(5) of the Commodity Exchange Act; (D) rights offerings, exchange offers, or offerings made pursuant to a merger or acquisition; (E) offerings of investment grade asset-backed securities; (F) offerings of convertible securities; (G) offerings of preferred securities; (H) offerings of an investment company registered under the Investment Company Act; (I) offerings of securities (in ordinary share form or ADRs registered on Form F-6) that have a pre-existing market outside of the United States; and (J) offerings of a business development company as defined in Section 2(a)(48) of the Investment Company Act, a direct participation program as defined in Rule 2310(a) or a real estate investment trust as defined in Section 856 of the Internal Revenue Code."

- *Flipping*: A prohibition on penalizing registered representatives of a FINRA Member whose customers have “flipped” a new issue unless a penalty bid has been imposed on the FINRA Member by the managing underwriter in connection with the distribution of the new issue. In addition, FINRA Members must promptly record and maintain information regarding any penalties or disincentives assessed on their associated persons in connection with a penalty bid.

In addition, the Adopted Rule contains the following requirements that will be imposed on FINRA Members in respect of the pricing of IPOs:

- *Pricing and Trading Practices*: The book-running lead manager must provide to the issuer a report of indications of interest, including the names of interested institutional investors and the number of shares indicated by each, and a report of aggregate demand from retail investors, and, after the IPO settlement date, a report of the final allocation of shares.
- *Lock-Up Agreement*: Any lock-up agreement or other restriction on the transfer of the issuer’s shares by officers and directors of the issuer entered into in connection with a new issue must provide that (1) such restrictions will apply to their issuer-directed shares, and (2) at least two business days prior to the release of any lock-up, the lead manager will notify the issuer and make an announcement through a major news service, except where the release is effected solely to permit a transfer of securities not for consideration and where the transferee has agreed in writing to be bound by the same lock-up agreement terms. FINRA confirms that this provision applies only to lock-up agreements entered into in connection with a new issue.
- *Agreement Among Underwriters*: Under the Adopted Rule, the agreement among syndicate members must provide that, to the extent not inconsistent with Regulation M, shares trading at a premium to the IPO price returned by a purchaser to a syndicate member after trading commences will be allotted to the syndicate short position, or, if no short position exists, the member must offer returned shares at the public offering price to unfilled customers’ orders pursuant to a random allocation methodology.
- *Market Orders*: No Member may accept a market order for the purchase of shares of a new issue in the secondary market prior to the commencement of trading of such shares in the secondary market.

Differences Between Amendment No. 3 and Amendment No. 4⁷

- *Spinning*: Amendment No. 4 made several substantive changes to Amendment No. 3 with respect to “spinning.”
 - Requirement to establish procedures: Amendment No. 4 imposes an obligation on FINRA Members to establish, maintain and enforce policies and procedures reasonably designed to ensure that investment banking personnel have no involvement or influence, directly or indirectly, in the new issue allocation decisions of the FINRA Member. In the Adopting Release, the SEC points out that FINRA believes that the procedures “are essential to managing conflicts of interest between investment banking and syndicate activities.”

⁷ The text of Amendment No. 4 is currently available at <http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p121827.pdf>.

- **Concept of covered non-public company:** Amendment No. 4 clarifies that the spinning provision would also apply to any account in which an executive officer or director of a public company or a “covered non-public company,”⁸ or a person materially supported by such executive officer or director, has a beneficial interest.⁹
- **Forward looking provision:** Amendment No. 4 prohibits new issue allocations only where the person responsible for making the allocation decision “knows or has reason to know that the member intends to provide, or expects to be retained by the company for, investment banking services within the next 3 months.” According to FINRA, this means that if a FINRA member maintains information barriers between the investment banking and syndicate departments, then the persons responsible for making new issue allocation decisions will neither know nor have reason to know of a prospective business relationship.
- **Written representations:** Supplementary Material / .02 to the Adopted Rule expressly permits a member to rely on written representations obtained within the prior 12 months from the beneficial owner(s) of the account (or a person authorized to represent the beneficial owner(s)) as to whether such beneficial owner(s) is an executive officer or director (or person materially supported by an executive officer or director) and if so, the company(ies) on whose behalf such executive officer or director serves. Consistent with current practice under FINRA Rule 5130, FINRA requires that the initial representation be an affirmative representation, but will permit such representation to be updated annually through the use of negative consent letters.
- **Recordkeeping responsibility:** Amendment No. 4 includes a provision requiring FINRA Members to maintain a copy of all records and information relating to whether an account is eligible to receive an allocation of the new issue for at least three years following the FINRA Member’s allocation to that account.
- ***Lock-up Agreement:*** In Amendment No. 4, FINRA clarifies that the required notice of an impending release or waiver of a lock-up may be announced either by the issuer or the applicable FINRA Member(s) so long as the announcement is made through a major news service at least two days before the release or waiver of any lock-up or other restriction on the transfer of the issuer’s shares; the requirement is satisfied irrespective of whether such announcement is made by the book-running lead manager, another FINRA Member or by the issuer.
- ***Agreement Among Underwriters:*** In Amendment No. 4, FINRA provides FINRA Members with additional flexibility in the handling of returned shares. However, FINRA continues to require that, to the extent not inconsistent with SEC Regulation M, the agreement between the book-running lead manager and other syndicate members must provide that any shares trading at a premium to the public offering price returned by a purchaser to a syndicate member after

⁸ The term “covered non-public company” means any non-public company satisfying the following criteria: (i) income of at least \$1 million in the last fiscal year or in two of the last three fiscal years and shareholders’ equity of at least \$15 million; (ii) shareholders’ equity of at least \$30 million and a two-year operating history; or (iii) total assets and total revenue of at least \$75 million in the latest fiscal year or in two of the last three fiscal years. The adopting release points out that these are the same quantitative listing standards for a national securities exchange.

⁹ “Beneficial interest” has the same meaning found in FINRA Rule 5130(i)(1). It is defined as any economic interest, such as the right to share in gains or losses. FINRA notes that the receipt of a management or performance based fee for operating a collective investment account, or other fees for acting in a fiduciary capacity, shall not be considered a beneficial interest in the account.

secondary market trading commences be used to offset the existing syndicate short position. However, where no syndicate short position exists, the FINRA Member has the option, provided that it is in accordance with SEC Regulation M, to either: (1) offer returned shares at the public offering price to unfilled customers' orders pursuant to a random allocation methodology or (2) sell returned shares on the secondary market and donate profits from the sale to an "unaffiliated charitable organization"¹⁰ with the condition that the donation be treated as an anonymous donation to avoid any reputational benefit to the FINRA Member.

Conclusion

Although existing securities laws already regulate FINRA Members' actions with respect to IPOs, including SEC Rule 10b-5, SEC Regulation M, and FINRA Rule 5310, the Adopted Rule contains important additional restrictions. The Adopted Rule is much broader than the Voluntary Initiative¹¹ in place at many investment banks to block new issue sales to officers and directors of public companies. Finally, it is important that financial institutions that have FINRA-Member investment banking operations consider and commence the work that will be required to implement these new restrictions.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

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¹⁰ Amendment No. 4 established a new definition of "unaffiliated charitable organization" to prevent such charitable donations from benefiting the FINRA Member or executive officers and directors of the FINRA Member (and persons they materially support).

¹¹ The Voluntary Initiative prohibited certain allocations to the account of any executive officer or director of a U.S. public company or a public company for which a U.S. market is the principal equity trading market with respect to all hot IPOs. Voluntary Initiative Regarding Allocations of Securities in "Hot" Initial Public Offerings to Corporate Executives and Directors, <http://www.sec.gov/news/press/globalvolinit.htm> (April 28, 2003).