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FINRA New Issue (IPO) Allocation Rule to Take Effect May 27, 2011; Investment Funds Must Now Consider Compliance

On November 29, 2010, FINRA announced in Regulatory Notice 10-60 (the “Adopting Notice”) that FINRA Rule 5131 (the “Rule”) regulating new issue allocations and distributions will take effect on May 27, 2011.¹ The Rule was first proposed by the NASD in 2002, was amended and reissued by the NASD in 2003 and 2004, and again in 2010, and was approved by the SEC on September 29, 2010.² Among other things, the Rule contains the following prohibitions.

“Spinning”³

- **Generally:** A general prohibition on the allocation by a FINRA member (a category comprising nearly all SEC-registered broker-dealers) of new issue securities⁴ to any account (which can include an investment fund) in which an executive officer or director of a public or covered non-public company⁵ has a beneficial interest, if:

(1) the company is currently an investment banking client of the member;

¹ The Adopting Notice is available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122490.pdf>.

² The following Shearman & Sterling publications describe the NASD’s 2002 proposal, the various amendments, and the SEC’s approval:

- *2002 Proposal:* “NASD Proposes New IPO Allocation and Distribution Rules” (September 12, 2002), available at http://www.shearman.com/sf_091902/.
- *2003 Amendment:* “NASD Reissues Proposed Rule Governing IPO Allocations and Distributions” (December 1, 2003), available at http://www.shearman.com/cm_1203_2/.
- *2010 Amendment:* “FINRA Amends 2002 Proposal Regarding IPO Allocation” (March 25, 2010), available at <http://www.shearman.com/finra-amends-2002-proposal-regarding-ipo-allocation-03-24-2010/>.
- *SEC approval:* “SEC Approves FINRA Rule Regarding IPO Allocation Practices” (October 13, 2010), available at <http://www.shearman.com/sec-approves-finra-rule-regarding-ipo-allocation-practices-10-13-2010/>.

³ “Spinning” refers to the practice of awarding IPO securities to the executive officers and directors of potential investment banking clients in exchange for investment banking business.

⁴ Under Rule 5131(e)(7), the term “new issue” has the same definition provided in 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.” However, the definition of new issue excludes certain types of offerings, including private placements, sales in certain restricted securities, offerings of investment grade asset-backed securities, offerings of convertible securities, offerings of securities that have a pre-existing market outside the United States, and offerings of an investment company registered under the U.S. Investment Company Act of 1940.

⁵ Under Rule 5131(e)(1), a “public company” is any company that is registered under Section 12 of the Securities Exchange Act of 1934 or files periodic reports pursuant to Section 15(d) thereof. Under Rule 5131(e)(3), a “covered non-public company” means any non-public company with: (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.

(2) in the 12-month period prior to the allocation, the member received compensation from the company for investment banking services;

(3) the FINRA member expects to provide or be retained for investment banking services in the three-month period following the allocation; or

(4) such allocation is made on the condition that such executive officer or director, on behalf of the company, retain the member for performance of future investment banking services.

Issuer-directed shares: The spinning prohibition does not apply to allocations of issuer-directed shares, so long as the member has no involvement or influence in such allocation decisions. The spinning prohibition requires that members 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 member.

Exceptions: The Rule excepts from its spinning prohibition allocations of new issues to certain types of accounts—which are generally consistent with the types of accounts excepted from the restrictions imposed by Rule 5130, the New Issue Rule, which prohibits sales of new issue securities to accounts in which a “restricted person” (generally, securities industry insiders) has a beneficial interest.⁶

The main area of divergence between the exceptions in Rules 5130 and 5131 is that Rule 5131 permits allocations of new issues to an account, including a collective investment vehicle such as a fund, in which the collective beneficial interests of executive officers and directors of a particular company and persons materially supported by such executive officers and directors in the aggregate do not exceed 25 percent of such account.⁷ By contrast, Rule 5130’s analogous exemption applies to accounts in which restricted persons have an aggregate beneficial interest of no greater than 10 percent.⁸

Compliance: To facilitate compliance with the spinning prohibition, the Rule permits members to rely on written representations obtained within the prior 12 months from the beneficial owner(s) of an account 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 or companies on whose behalf such executive officer or director serves. The initial representation must be an affirmative representation, but subsequently may be updated annually through the use of negative consent letters. FINRA has reminded its members, however, that they may not rely upon any representation that they believe, or have reason to believe, is inaccurate.⁹

⁶ The Rule follows Rule 5130 in permitting unlimited allocations of new issue securities, subject to certain conditions, to U.S.-registered investment companies, common trust fund accounts, insurance company accounts, certain publicly traded entities listed or eligible to be listed on a U.S. exchange, non-U.S. investment companies, ERISA plans, state or municipal benefits plans, 501(c)(3) organizations and 414(e) church plans.

⁷ In this regard, SEC Release 34-63010, adopting FINRA’s Amendment No. 4 (“SEC Adopting Release”) states: “FINRA notes that hedge funds would be included where the beneficial interest of executive officers and directors of of a particular company (and materially supported persons) in the aggregate exceed 25%. FINRA continues to believe that the 25% threshold is most appropriate and therefore will not increase the standard to 50% as requested by one commenter.” (Emphasis added.) See the SEC Adopting Release at footnote 20. The SEC Adopting Release is currently available at <http://www.sec.gov/rules/sro/nasd/2010/34-63010.pdf>.

⁸ Under the New Issue Rule 5130, the 10 percent “de minimis” exemption is both a threshold exemption for accounts with fewer than 10 percent restricted holders and an allocation device, permitting a collective investment vehicle to limit the profit and loss from new issue securities to no more than 10 percent. It remains to be seen whether FINRA will permit similar limiting procedures in respect of Rule 5131. For a description of the New Issue Rule, please 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/>.

⁹ See the [Adopting Notice](#) at endnote 8.

Compliance requirements for private investment funds

Equally important to market participants is that private investment funds, such as hedge funds, will be asked by broker-dealers to make a representation regarding their eligibility to acquire IPO securities in accordance with this new rule, as they now do with respect to the New Issue Rule. We note that the definition of “new issue” does not by its terms exclude non-US IPOs (other than IPOs of companies with a pre-existing market outside the United States).

In order to make such a representation, collective investment vehicles, such as funds, will need to diligence their investor base to assess whether 25% or more of their beneficial economic ownership is in the hands of executive officers and directors of any particular public or covered non-public company. This will require fresh attention to fund subscription agreement provisions.

Other significant regulations found in Rule 5131

- **Quid Pro Quo Allocations:** A prohibition on the offer of new issue securities or the threat to withhold new issue securities as consideration or inducement for the receipt of compensation that is “excessive” in relation to the services provided to the customer by the FINRA member. The Adopting Notice states that 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.¹⁰ Commenters had noted that the term “excessive” is subject to uncertainty, and requested guidance from FINRA in the Rule itself.¹¹ FINRA declined to amend the Rule, however, stating that the Rule’s language provides the appropriate amount of regulatory flexibility. FINRA noted that it does not intend that the prohibition interfere with legitimate customer relationships.

FINRA further stated that the provision on quid pro quo allocations is not intended to prohibit a FINRA member from allocating new issue securities to a customer merely because the customer has separately availed itself of other services, when the customer has not paid excessive compensation in relation to those services. Trading activity that serves no economic purpose other than to generate compensation for the member (such as certain wash sales) would be considered excessive. If a wash sale has an economic purpose, such as tax planning, that factor will be considered in assessing whether the transaction has an economic purpose and, in turn, whether the trading fees for such sales are excessive.¹²

- **Policies Concerning 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 member by the managing underwriter. 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 Rule contains the following requirements 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.

¹⁰ See the [Adopting Notice](#) at p. 2.

¹¹ See SIFMA’s Comment Letter of April 8, 2010 at p. 2, available at <http://www.sec.gov/rules/sro/nyse/nyse200412/nasd2003140-14.pdf>.

¹² See the [Adopting Notice](#) at endnote 5.

- **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 such restrictions will also apply to any issuer-directed shares received by such officers or directors. In addition, the agreement must require that 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. In this respect, FINRA has reasoned that given the importance of lock-ups for investors, underwriters should not be permitted to waive lock-ups without providing prior notice to market participants. FINRA confirms that these provisions apply only to lock-up agreements entered into in connection with a new issue.¹³

According to FINRA guidance, any news service permitted to be used to provide public disclosure of material information under SEC Regulation FD would satisfy the Rule's requirement that public disclosure be made through a "major news service." However, FINRA has also noted the caveat that, as is also required by Regulation FD, it is important that the method or methods used to provide such disclosure be reasonably designed to provide broad, non-exclusionary distribution of the required information to the public. Therefore, in announcing the required information, members are expected to select a disclosure method that is likely to result in the actual public dissemination of the specified information.

FINRA would consider disclosure of a release or waiver in a publicly-filed registration statement in connection with a secondary offering as satisfying the requirement for an announcement through a major news service.¹⁴ FINRA has stated, however, that disclosure on Form 8-K by the issuer would not be sufficient to comply with the Rule's disclosure requirements.¹⁵

- **Agreement Among Underwriters:** Under the 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, or sell returned shares on the secondary market and donate profits from the sale to an unaffiliated charitable organization with the condition that the donation be treated as an anonymous donation to avoid any reputational benefit to the member.
- **Market Orders:** No FINRA 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.

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 5130, the Rule contains important additional restrictions. The Rule is also broader than the Voluntary Initiative¹⁶ in place at many investment banks to restrict new issue sales to officers and directors of public companies. It

¹³ See Rule 5131(d)(2) and the SEC Adopting Release at page 18.

¹⁴ See the [Adopting Notice](#) at endnote 12.

¹⁵ See the SEC release relating to Amendment No. 2 of the Rule at p. 17, available at <http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p010729.pdf>.

¹⁶ 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, available at <http://www.sec.gov/news/press/globalvolinit.htm> (April 28, 2003).

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 publication 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.

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