SHEARMAN & STERLING LLP

Client Publication

Financial Institutions Advisory & Financial Regulatory, Capital Markets | March 25, 2010

FINRA Amends 2002 Proposal Regarding IPO Allocation

On February 17, 2010, the U.S. Financial Industry Regulatory Authority ("FINRA") filed with the Securities and Exchange Commission ("SEC") Amendment No. 3 to its proposed rule regarding allocations and distributions of shares in IPOs (the "Proposed Rule").[1]

The Proposed Rule was first proposed by NASD in 2002 as NASD Rule 2712,[2] and was amended and reissued by the NASD in both 2003 and 2004.[3] The amendment to the rule, now designated FINRA Rule 5131, makes certain incremental substantive changes (including to the prohibitions on spinning, lock-up agreements, and market orders), responds to commenters' concerns regarding certain provisions, and seeks to clarify and streamline the Proposed Rule.

Summary of Proposal

As revised, the Proposed Rule contains the following basic aspects:

- *Quid Pro Quo Allocations:* A prohibition on the offer to allocate, or threat to withhold allocation of, IPO securities in exchange for the receipt of compensation that is excessive in relation to the services provided to the customer by the FINRA Member.
- *Spinning:* A prohibition on the allocation of IPO securities to the account of an executive officer or director of a company[4] (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 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-

[1] For more information regarding the Proposed Rule, 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.

[2] See "*NASD Proposes New IPO Allocation and Distribution Rules*" (September 12, 2002), available at http://www.shearman.com/sf_091902/.

[3] See "*NASD Reissues Proposed Rule Governing IPO Allocations and Distributions*" (December 1, 2003), available at http://www.shearman.com/cm_1203_2/.

[4] "Account of an executive officer or director" means any account in which such executive officer or director, or a person materially supported by such executive officer or director, has a financial interest or has discretion or control, except for (1) a registered investment company, or (2) any other investment fund unless such officer, director, or materially supported person has a 25% or more interest in such fund. "Material support" means providing more than 25% of a person's income in the prior calendar year. Persons living in the same household are deemed to be providing each other with material support.

directed shares, so long as the Member has no involvement or influence in such decisions.

- *Flipping:* A prohibition on penalizing registered representatives of a FINRA Member whose customers have "flipped" IPO securities unless a penalty bid has been imposed on the Member by the managing underwriter in connection with the distribution of IPO securities.

In addition, the Proposed 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 under the Proposed Rule provide to the issuer a regular 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 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 provision, 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.
- *Agreement Among Underwriters:* Under the Proposed 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 offered returned shares at the public offering price to unfilled customers' orders pursuant to a random allocation methodology.
- *Market Orders:* No Members may accept a market order for the purchase of IPO shares prior to commencement of trading on the secondary market.

Differences Between 2004 amendment and Current Amendment

- *Quid Pro Quo Allocations:* The text of the Proposed Rule remains unchanged regarding such allocations, but it is noteworthy that commenters sought clarification on what would constitute excessive compensation. FINRA's response indicates that the test continues to be one based on facts and circumstances, but it did note that "trading activity that serves no economic purpose other than to generate compensation for the member (such as certain wash sales) would be considered excessive."[5]
- *Spinning:* The amendment clarifies that officers and directors of current investment banking clients are included in the spinning prohibitions. In addition, the proposal shortens from six months to three months the period after the IPO allocation during which the prohibitions on "spinning" allocations are operative. FINRA has also eliminated the presumption that all allocations within such period are violations of the Proposed Rule, and it will instead conduct a factual investigation to determine whether impermissible allocations have been made. Finally, the amendment adds a carve-out for allocations of issuer-directed shares.
- *Lock-up Agreement:* The amendment exempts from the Proposed Rule's notice and disclosure requirements those lock-up waivers effected solely to permit transfers of securities that are not for consideration and where the transferee has agreed

[5] See pp. 10-11 of the Proposed Rule.

in writing to be bound by the same lock-up

- *Agreement Among Underwriters:* The amendment provides that the provision governing treatment of returned shares would only be applicable where such shares are trading at a premium to their IPO price, since the ability to purchase at the IPO price does not otherwise confer an economic benefit. In addition, because a reallocation of returned shares could technically extend the distribution of securities for purposes of SEC Regulation M, FINRA reminds Members of their responsibility to undertake reallocation in a manner consistent with Regulation M, and has noted that it will work with the SEC in applying the Proposed Rule in a manner that does not conflict with Regulation M.
- *First-day Marker Orders:* The Proposed Rule had previously prohibited acceptance of market orders during the *first day* that IPO shares trade on a secondary market. However, the amendment now merely prohibits acceptance of market orders immediately *prior* to the commencement of secondary market trading in the IPO.

Conclusion

Although existing securities laws already regulate Members' actions with respect to IPOs, including SEC Rule 10b-5, SEC Regulation M, and FINRA Rule 5310, the Proposed Rule contains important additional restrictions.

agreement terms.

In taking up the Proposed Rule six years after the last amendment, FINRA has addressed some of the concerns relating to the Proposed Rule, but has left other considerations unaddressed for the time being. One example is the proposed implementation of prohibitions on IPO allocations to corporate clients' officers and directors that may operate in a manner similar to Rule 5310 (the "New Issue Rule"), without many of the definitions, exceptions, and exclusions that are contained in that complex rule.[6] Also unclear at this time is how the Proposal Rule's adoption, if and when it occurs, will affect similar initiatives that have been made by the SEC relating to IPO allocation and distributions.[7]

---

[6] Another significant question relates to the effect of the Proposed Rule on the SEC's Voluntary Initiative Regarding Allocation of Securities in "Hot" Initial Public Offerings to Corporate Executives and Directors, which restricts allocation of "Hot" IPOs to an account of an executive officer or director of a U.S. public company or a company for which the U.S. market is the principal equity trading market. Though technically expired, the Voluntary Initiative continues to be adhered to as an industry standard by many FINRA Members. For the terms of the Voluntary Initiative, please see http://www.sec.gov/news/press/globalvolinit.htm.

[7] *See* "*SEC Proposed Amendments to Regulation M*" (October 14, 2004), available at http://www.shearman.com/cm_101404/.

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:

Charles S. Gittleman
New York
+1.212.848.7317
cgittleman@shearman.com

Russell D. Sacks
New York
+1.212.848.7585
rsacks@shearman.com

Michael J. Blankenship
New York
+1.212.848.8531
michael.blankenship@shearman.com

Steven Blau
New York
+1.212.848.8534
steven.blau@shearman.com