

Notices

Regulatory Notices

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Risk Management

Funding and Liquidity Risk Management Practices

Executive Summary

In adverse circumstances, whether the result of firm-specific events or systemic credit events, the cost of funding a broker-dealer's operations could become prohibitively expensive; in extreme cases funding could become unavailable. FINRA expects broker-dealers to develop and maintain robust funding and liquidity risk management practices to prepare for adverse circumstances. Further, FINRA expects broker-dealers affiliated with holding companies to undertake these efforts at the broker-dealer level, in addition to their planning at the holding-company level. We are publishing this *Notice* to provide guidance in this effort.

Many of the practices outlined in this *Notice* were identified through FINRA examinations and a survey of 15 mid-sized and large broker-dealers that hold inventory positions and carry customer accounts. This *Notice* does not provide a comprehensive description of all appropriate funding and liquidity risk management practices. Each broker-dealer should determine which practices are best suited to its particular business, whether or not they are mentioned in this *Notice*. While much of the content in this *Notice* is directed to broker-dealers that carry inventory positions, other broker-dealers may also find it to be a valuable resource.

Questions regarding this *Notice* may be directed to:

- ▶ Eric Moss, Vice President, Emerging Regulatory Issues, or Mo Saleh, Director, Emerging Regulatory Issues, at (202) 728-8472.
- ▶ Amr M. El-Sabbagh, Director, Risk Oversight and Operational Risk, at (646) 315-8739.

November 2010

Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Finance
- ▶ Internal Audit
- ▶ Legal and Compliance
- ▶ Risk Management Committee
- ▶ Risk Managers
- ▶ Senior Management
- ▶ Treasury

Key Topics

- ▶ Concentration Risk
- ▶ Contingency Funding Plan
- ▶ Funding and Liquidity Risk Management
- ▶ Independent Inventory and Collateral Valuation

Referenced Rules and Notices

- ▶ NTM 99-92
- ▶ SEA 15c3-3

Background and Discussion

The effectiveness of broker-dealer risk management practices is a subject of longstanding regulatory interest.¹ The recent financial crisis has provided many important lessons for risk managers.² One lesson, and the primary theme of this *Notice*, is that broker-dealers need to develop and monitor funding and liquidity risk management programs that take into consideration a broad range of adverse circumstances, including extraordinary credit events. The first days of a crisis may be the most critical; therefore, broker-dealers must prepare for distressed credit markets before a crisis hits.

Sound Practices for Funding and Liquidity Risk Management

FINRA expects broker-dealers to regularly assess their funding and liquidity risk management practices to maximize the likelihood that they can continue to operate under adverse circumstances, whether the result of broker-dealer-specific events or systemic credit events. Broker-dealers affiliated with holding companies are expected to conduct this analysis and develop contingency funding plans at the broker-dealer level, in addition to their planning at the holding-company level. Assessing funding and liquidity risks at the broker-dealer level enables the governing boards and senior management of broker-dealers to measure, monitor and control for risks unique to the broker-dealer. Further, this level of analysis can help broker-dealers plan for the challenges they would face should access to funding from affiliated entities become limited or even unavailable.

The following practices can help broker-dealers prepare for various market scenarios, such as loss of funding sources, unanticipated deteriorations of asset quality, contagion across markets and future earnings volatility that could affect their liquidity positions and ability to fund operations. This *Notice* does not provide an exhaustive description of all appropriate funding and liquidity risk management practices. Each broker-dealer should consider the practices that are best suited to its operations, whether or not they are mentioned in this *Notice*.

Risk Limits and Reporting

The governing board and senior management of a broker-dealer should be fully informed on the firm's risk management policies and procedures, and should participate in setting and periodically re-evaluating the level of funding and liquidity risk the organization is willing to accept to meet its business goals. Senior management should ensure that these determinations are communicated throughout the organization so that management in the various business lines can set appropriate funding and liquidity risk limits and evaluate existing risks presented by various markets and counterparties.³

It is equally important for broker-dealers to maintain robust systems that timely capture funding and liquidity exposure across all of their business lines. The scope and frequency of the information analyzed by broker-dealers should occur as necessary given an organization's size, complexity and the presence of red flags discussed below. It is critical that broker-dealers have escalation procedures to report instances where pre-established funding and liquidity limits are exceeded to the appropriate level of management, including provisions for determining when such breaches should be immediately reported to senior management. The appropriate broker-dealer staff (*e.g.*, treasury) also should consider reviewing with senior management on a regular basis formal risk reports—both quantitative and qualitative—that summarize key measures of funding and liquidity, such as:

- the amount of excess liquidity currently available;
- future cash-flow projections based on multiple scenarios, including under stressed conditions;
- the maturity profile of available funding sources;
- liquidation and mark-down assumptions for inventory positions, including those based on mark-to-model values;
- price volatility and correlation trends with respect to certain asset classes;
- inventory concentrations in related asset classes;
- the usage and limits of secured and unsecured lines of credit;
- how existing risk levels compare with pre-established risk limits;
- the level of funding through particular markets and position concentrations for certain counterparties; and
- the ability to timely monetize assets that have been set aside in an excess liquidity pool.

Independent Risk Oversight

Broker-dealers are encouraged to use staff that is independent of business lines to ensure that the firm does not exceed the levels of risk tolerance set by the governing board and senior management. The staff may perform such functions as analyzing exposure across business lines, monitoring for early warning signs concerning potential funding and liquidity problems, evaluating pricing decisions, performing stress tests, and maintaining and regularly updating contingency funding plans. Regardless of whether the staff works in departments dedicated to risk management functions or in other departments independent of business lines, firms should ensure that the staff has sufficient resources and authority.

Further, many broker-dealer funding and liquidity risk management programs are supported by committees that include senior managers who oversee key functions such as trading desks, treasury operations, credit risk, market risk and collateral management. These committees can help evaluate risk across business lines at the broker-dealer and ensure that relevant information is appropriately shared. Broker-dealers are encouraged to periodically review the charters and mission statements for these committees to ensure that they reflect prevailing market developments and organizational structures.

Maturity Profile of Funding Sources

Over reliance on shorter-term funding to finance longer-term assets was a significant factor in the severe difficulties faced by some financial firms during the credit crisis. Broker-dealers that use shorter-term financing to fund longer-term positions should regularly assess their ability to continue operating under a variety of market conditions and firm-specific events. Some broker-dealers that use shorter-term funding to finance longer-term assets have determined that they should reduce their exposure to the very short-term credit market. These broker-dealers are diversifying funding sources and laddering the maturity profile of liabilities. Broker-dealers should consider the following steps in order to match-fund holding periods:

- extend maturity terms beyond overnight for repurchase agreement (repo) positions or other short-term funding sources;⁴ and
- establish irrevocable lines of credit or other supplementary sources of short-term funding.

Greater reliance on shorter-term financing to fund longer-term assets elevates the significance of funding and liquidity risk indicators, such as the level of excess liquidity, inventory quality and holding periods, inventory and counterparty concentration exposure, costs of funding and projected cash-flows.

Red Flags of Potential Funding and Liquidity Problems

Many broker-dealers have programs designed to monitor for early warning signs of potential funding and liquidity problems. Red flags should trigger management to take immediate action or perform additional monitoring. Broker-dealers should consider the following red flags:

- significant increases in the cost of funding operations, including those that are firm specific and those based on changes in the interest rate environment;
- unexpected increases in exposure to certain asset classes, markets and counterparties;

- elevated costs of holding particular asset classes;
- sudden difficulty in entering into longer-term funding arrangements;
- significant increases in the proportion of the broker-dealer's longer-term assets funded through shorter-term markets, such as the overnight repo market;
- downgrades or announcements of potential downgrades of the credit ratings assigned to the public debt of the broker-dealer or its parent;
- downgrades or announcements of potential downgrades of the credit ratings assigned to collateral pledged by the broker-dealer;
- negative publicity or rumors targeted at the broker-dealer or parent that could reduce its perceived credit worthiness;
- widening spreads in the credit default swap market that suggest concerns about the credit worthiness of the broker-dealer or its parent;
- significantly widened credit spreads for the public debt of the broker-dealer or its parent;
- significant decline in earnings or projected earnings for the broker-dealer or its parent;
- increases in demands for funding by affiliates, as this may negatively affect the parent's ability to fund the broker-dealer;
- cancellation of external funding sources and non-renewal of maturing debt (*e.g.*, uncommitted repo or revolving credit facilities);
- imposition of increased collateral requirements and wider haircuts by counterparties, carrying broker-dealers⁵ and clearing organizations;
- excessive reliance on customer assets (cash and securities held in margin accounts) to help fund operations;
- significant reductions in the market value of certain asset classes held in inventory;
- breaches of pre-established risk limits;
- difficulty in timely monetizing the broker-dealer's assets in an excess liquidity pool;
- significant decline in the amount of excess liquidity available;
- unexpected demands for cash arising from contingent liabilities (*e.g.*, pending lawsuit);
- notable increases in collateral disputes with counterparties;
- assets returning to the balance sheet from customers with explicit or implicit puts that require immediate unanticipated funding; and
- deterioration in the financial condition of the broker-dealer or its parent that may trigger loan covenants or other credit events.

Inventory Valuation

Strong practices for identifying the true liquidation value of inventory holdings are essential for an effective funding and liquidity management program. The recent financial crisis highlighted the value of using staff that is technically competent and independent from the lines of business to evaluate pricing decisions, and empowering them to challenge pricing assumptions. Additionally, broker-dealers should consider using controls to ensure that:

- they value securities and derivative instruments daily based on current fair values;
- each business line correctly and consistently categorize assets;
- they use consistent prices across business lines, so that each security has only one price across the broker-dealer's inventory positions, reverse repo, repo and customer collateral;
- re-evaluate valuation methodologies periodically (with greater frequency in rapidly changing market conditions) and when realized results have deviated from results that were expected based on the firm's methodologies; and
- inputs and resources used in verifying prices are well-documented and independent from the trader.

It is important that material deviations from expected results be reviewed with senior management for all product lines. Materiality thresholds for bringing discrepancies to the attention of senior management should be reasonable and agreed to by internal and external auditors. Senior management also should be informed of modeling assumptions used to value securities held in inventory, particularly less liquid products. Broker-dealers are encouraged to establish procedures for senior management to formally approve price modeling assumptions. Further, broker-dealers are encouraged to develop policies and procedures for determining the circumstances under which they share pricing information with the governing board.

Stress Testing

An effective stress-testing program can help a broker-dealer identify and quantify sources of potential liquidity strains and analyze effects on its cash-flows, profitability and solvency. Accordingly, broker-dealers should consider performing stress tests on a regular basis that contemplate firm-specific and market-wide events, for varying time horizons (*e.g.*, one day, one month, one year), and varying levels of liquidity duress (*e.g.*, moderate, high and severe). The test results can help a broker-dealer assess whether it has sufficient excess liquidity in the form of unencumbered and highly marketable securities to meet possible funding shortfalls without the need to sell less

liquid assets at fire-sale prices or depend on additional funding from credit-sensitive markets. Broker-dealers should consider including the impact of the following in their stress testing programs:

- significant increases in the cost of funding operations, including those that are firm-specific and those based on broad credit market conditions;
- significant increases in the exposure to certain asset classes, markets and counterparties;
- significant erosion in inventory value resulting from a contagion across multiple asset classes or a change in the interest rate environment;
- loss of partial or complete access to particular funding sources or ability to finance particular asset classes;
- withdrawal of customer assets (cash and securities held in cash and margin accounts) that the broker-dealer uses to finance operations;
- sudden reductions in the market value of collateral, including those that could lead a counterparty, clearing broker-dealer and clearing organization to demand additional collateral or the broker-dealer to liquidate positions at fire-sale prices;
- reduction in the value of assets held in an excess liquidity pool;
- off-balance sheet assets (*e.g.*, securitized loans) coming back on to the balance sheet;
- unexpected demands for cash arising from contingent liabilities (*e.g.*, pending lawsuit);
- significant declines in earnings or projected earnings of the broker-dealer or parent;
- deterioration in the financial condition of the broker-dealer or parent that may trigger loan covenants or other credit event;
- increased demands for funding by affiliates, as this may affect the parent's ability to fund the broker-dealer;
- rating downgrade of the broker-dealer, its parent or collateral pledged by the broker-dealer; and
- negative publicity or rumors about the broker-dealer or parent that could make it more difficult to obtain funding.

The results of stress testing should be reviewed with senior management. Broker-dealers are encouraged to establish procedures for senior management to formally sign-off on the test results. Additionally, the test results may provide useful information for updating contingency funding plans.

Contingency Funding Plan

In a credit crisis, management may have little time to react and few options available to access funding and generate liquidity. A contingency funding plan can help a broker-dealer prepare for such situations and assist in its efforts to prudently and efficiently manage extraordinary fluctuations in liquidity. Accordingly, the governing boards and senior management of broker-dealers should consider maintaining and regularly updating contingency funding plans to:

- clarify responsibilities and decision-making authority, so that all personnel understand their role during a potential credit crunch;
- match sources of funds with contractual and potential obligations;
- list contingency funding sources and identify when they should be employed;
- identify business restrictions and reductions that may be employed to counteract a strain on liquidity, such as reducing certain trading positions, limiting or reducing margin loans, calling for additional margin or collateral from customers or other measures that may be needed to manage liquidity risks; and
- identify the various operational conditions that could affect access to back-up credit lines, such as credit rating triggers or loan covenants (*e.g.*, leverage ratios) and outline plans in the event of loss of such funding sources.

Broker-dealers are encouraged to establish procedures for senior management and governing boards to formally sign off on the contingency funding plans.

Use of Customer Assets

Under Exchange Act Rule 15c3-3, a carrying broker-dealer must calculate what amount, if any, it must deposit on behalf of customers in its reserve bank account for the exclusive benefit of customers (reserve bank account), according to the prescribed formula (reserve formula). Generally, under the reserve formula, a carrying broker-dealer must determine the amount of cash it owes to its customers and the amount of funds generated through the hypothecation of customer securities (*i.e.*, credits), and compare this amount to any amounts its customers owe it (*i.e.*, debits). If customer credits exceed customer debits, a carrying broker-dealer must deposit the net amount in its reserve bank account. Under Rule 15c3-3, this computation must be made weekly, for those firms that carry customer funds exceeding \$1 million, as of the close of the last business day of the week, and the deposit must be made no later than the second business day following the computation.

Carrying broker-dealers are cautioned that taking advantage of the fact that the reserve formula is only required to be computed weekly by using customer assets (cash and securities held in margin accounts) in the interim period to help fund operations can create unacceptable risks. Excessive reliance on this approach may be an indication of funding and liquidity stress. Carrying broker-dealers are encouraged to:

- establish and enforce limits on the use of customer cash and the hypothecation of customer securities; and
- consider developing contingency plans to prepare for possible customer withdrawal of assets, particularly at an accelerated rate.⁶

Conclusion

FINRA urges broker-dealers to take a proactive approach to reviewing and improving their funding and liquidity risk management practices. We recognize that the appropriateness of particular policies and procedures will vary depending on a broker-dealer's size and structure, and are publishing the above sound practices as a tool for firms to draw upon. FINRA notes that even the most elaborate procedures will not be effective unless they are rigorously followed.

Endnotes

- 1 In 1999, in response to changes in the industry and breakdowns in some risk management programs, the Securities and Exchange Commission, New York Stock Exchange and NASD issued the *Broker-Dealer Risk Management Practices Joint Statement* that emphasized the importance of maintaining an appropriate risk management system. See *NASD Notice to Members 99-92*.
- 2 Regulators and industry groups have published several reports that describe the lessons for risk managers from the recent financial crisis. Among these is a report issued by the Senior Supervisors Group (SSG) on October 21, 2009, entitled *Risk Management Lessons from the Global Banking Crisis of 2008*. The SSG is a forum composed of regulators, including the

Securities and Exchange Commission, the Federal Reserve System and the Office of the Comptroller of the Currency.

Further, in response to concerns about the infrastructure of the tri-party repurchase agreement (repo) market, a major source of funding for some broker-dealers, the Federal Reserve Bank of New York (FRBNY) asked market participants in the fall of 2009 to review and make recommendations regarding opportunities for improvement to the tri-party repurchase infrastructure. The Task Force on Tri-Party Repo Infrastructure was subsequently formed, and on May 17, 2010, the FRBNY published for comment the Task Force on Tri-Party Repo Infrastructure's recommendations and its initial response to them. Although

Endnotes

- the Task Force focused on eliminating to the greatest extent possible clearing banks' extensions of intraday credit (a significant risk to the tri-party market), the Task Force discussed other important issues, such as the importance of effective funding and liquidity risk management.
- In addition, in April (and revised in May) 2010, the FRBNY also published a staff report entitled *Repo Runs* that highlights risks related to short-term funding through the repo market, including the possibility that the failure of a large dealer could prompt the liquidation of large amounts of assets and create fire-sale conditions.
- Other reports that provide guidance to institutions on risk management practices in response to the recent financial crisis include *Observations on Risk Management Practices during the Recent Market Turbulence* (SSG, March 6, 2008); *Containing Systemic Risk: The Road to Reform* (Counterparty Risk Management Policy Group III, August 6, 2008); *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations* (Institute of International Finance, July 2008); *Financial Risk Outlook 2010* (Financial Services Authority).
- 3 While it may be appropriate for senior management to delegate certain funding and liquidity risk functions to others in the organization, senior management nevertheless retains ultimate responsibility for the broker-dealer's funding and liquidity risk management issues. Accordingly, senior management should take reasonable and appropriate action to ensure that functions are properly delegated and executed.
 - 4 A repo is economically similar to a secured loan, whereby a borrower surrenders securities for a cash loan generally at a fixed rate of interest. In a repo, the borrower agrees to sell immediately the securities to the lender, and the borrower agrees to buy back the same securities from the lender at a fixed price and date. Most repo transactions mature on a daily basis although some are for longer periods. A reverse repo is the same transaction, but from the lender's perspective.
 - 5 Many introducing broker-dealers rely on their carrying broker-dealer as the primary source of funding to facilitate customer and proprietary trading. Carrying broker-dealers may obtain such funding through bank credit lines or the repo and securities lending markets.
 - 6 In March 2008, Bear Stearns' prime brokerage customers became concerned about the firm's ability to meet its obligations. These customers transferred their accounts to competitors perceived to be of higher credit quality and, in the process, withdrew substantial amounts of customer credit balances within the course of one week.

BD and IA Renewals for 2011

Broker-Dealer, Investment Adviser Firm, Agent and Investment Adviser Representative, and Branch Renewals for 2011

Payment Deadline: December 13, 2010

Executive Summary

The 2011 Renewal Program begins on November 15, 2010, when FINRA makes available the online Preliminary Renewal Statements to all firms on Web CRD/IARD.

Firms should note the following key dates in the 2011 renewal process:

October 25, 2010*	Firms may begin submitting post-dated Form U5 and BR Closing/Withdrawal filings via Web CRD/IARD.
November 1, 2010*	Firms may begin submitting post-dated Form BDW and ADV-W filings via Web CRD/IARD.
November 15, 2010	Preliminary Renewal Statements are available on Web CRD/IARD.
December 13, 2010	Full payment of Preliminary Renewal Statements is due.
January 3, 2011	Final Renewal Statements are available on Web CRD/IARD.
February 4, 2011	Full payment of Final Renewal Statements is due.

***Please Note:** Post-dated filings submitted by 11 p.m., Eastern Time (ET), November 12, 2010, do not appear on the firm's Preliminary Renewal Statement. The only allowed date for post-dated termination filings is December 31, 2010.

November 2010

Notice Type

- Renewals

Suggested Routing

- Compliance
- Legal
- Operations
- Registered Representatives
- Registration
- Senior Management

Key Topics

- IARD™
- Registration
- Renewals
- Web CRD®

Referenced Rules & Notices

- NTM 02-48

FINRA advises firms that failure to remit full payment of their Preliminary Renewal Statements by December 13, 2010, may cause the firm to become ineligible to do business in the jurisdictions where it is registered, effective January 1, 2011.

In addition to this *Notice*, firms should review the instructions posted at www.finra.org/renewals, especially the *2011 Renewal Program Bulletin*, the *2011 IARD Renewal Program Bulletin* (if applicable) on the Investment Adviser Registration Depository (IARD) website at www.iard.com/renewals.asp, and any information mailed to ensure continued eligibility to do business as of January 1, 2011.

Please direct questions concerning this *Notice* to the FINRA Gateway Call Center at (301) 869-6699.

Background & Discussion

Preliminary Renewal Statements

Beginning **November 15, 2010**, Preliminary Renewal Statements are available for viewing and printing on Web CRD/IARD. The statements include the following fees:

- Web CRD system processing fees;
- FINRA branch office fees;
- FINRA branch renewal processing fees;
- American Stock Exchange (AMEX), BATS Y-Exchange, Inc. (BATS-YX), BATS Z-Exchange, Inc. (BATS-ZX), Boston Stock Exchange (BX), Chicago Board Options Exchange (CBOE), Chicago Stock Exchange (CHX), International Securities Exchange (ISE), NASDAQ Stock Exchange (NOX), New York Stock Exchange (NYSE), NYSE Arca, Inc. (ARCA) and Philadelphia Stock Exchange (PHLX) maintenance fees;
- state agent renewal fees;
- state BD renewal fees;
- state BD branch fees;
- investment adviser firm and representative renewal fees, if applicable; and
- broker-dealer and/or investment adviser branch renewal fees.

FINRA must receive full payment of the Preliminary Renewal Statement fees no later than December 13, 2010.

If payment is not received by December 13, 2010, FINRA-registered firms will be assessed a Renewal Payment Late Fee. FINRA includes this late fee as part of the Final Renewal Statement and calculates the fee as follows: 10 percent of a firm's cumulative final renewal assessment or \$100, whichever is greater, with a cap of \$5,000. Please see *Notice to Members (NTM) 02-48* for details. In addition, if FINRA fails to receive payment by the deadline, firms also risk becoming ineligible to do business in the jurisdictions where their registrations are not renewed.

Fees

FINRA assesses a fee of \$30 for each registered representative who renews his/her registration with any regulator through Web CRD. Firms can access a listing of agents assessed this fee by requesting the Renewals—Firm Renewal Roster.

In addition, any investment adviser fees assessed by the North American Securities Administrators Association (NASAA) for state-registered investment adviser firms and investment adviser representatives (RA) who renew through IARD will also be included on the Preliminary Renewal Statement.

Based on the number of active FINRA branches on December 31, 2010, FINRA assesses each firm a branch office assessment fee of \$75 per branch. FINRA waives one branch office assessment fee per firm.

Based on the number of active FINRA branches on December 31, 2010, FINRA assesses each firm a FINRA branch renewal processing fee of \$20 per branch. FINRA waives one branch renewal processing fee per firm.

Please note that FINRA does not assess the personnel assessment fees through the annual Renewal Program. FINRA will mail all FINRA-registered firms a separate invoice for these fees. Firms can obtain a listing of agents for whom the firms will be assessed the personnel assessment fee by requesting the Renewals—Firm Renewal Roster.

Web CRD/IARD assesses renewal fees for AMEX, ARCA, BATS-YX, BATS-ZX, BX, CBOE, CHX, ISE, NOX, NYSE, PHLX and state registrations on the Preliminary Renewal Statement. The system displays the applicable fees for the number of individuals registered in each SRO and jurisdiction.

Web CRD/IARD assesses branch office renewal fees for those regulators that choose to renew branches registered with them in Web CRD/IARD.

Some participating jurisdictions may require steps beyond the payment of renewal fees to FINRA to complete the broker-dealer or investment adviser renewal process. Firms should contact each jurisdiction directly for further information on state renewal requirements. A Regulator Directory is located at www.nasaa.org/QuickLinks/ContactYourRegulator.cfm.

For detailed information regarding 2011 investment adviser renewals, you may also visit the IARD website, www.iard.com. A matrix of investment adviser renewal fees for states that participate in the 2011 IARD Renewal Program is posted at www.iard.com/fees.asp.

Renewal Payment

Firms have four payment methods available to pay 2011 renewal fees:

1. Automatic Daily Account-to-Renewal Account Transfer
2. Web CRD/IARD E-Pay
3. Check
4. Wire Transfer

Automatic Daily Account-to-Renewal Account Transfer

FINRA will automatically transfer funds from a firm's Daily Account to its Renewal Account to facilitate payment of renewal fees on December 13, 2010, the Preliminary Renewal Statement payment deadline. FINRA will transfer funds only if a firm has sufficient funds available in its Daily Account on December 13 to cover the amount due. **Please Note:** If a firm does not want funds automatically transferred, the firm should ensure FINRA receives payment in its Renewal Account by the deadline. Separately, if a firm wishes to transfer funds between affiliated firms, the firm should submit a Web CRD/IARD Account Transfer Form available on the FINRA website at www.finra.org/crd/transferform.

Web CRD/IARD E-Pay

The Web CRD/IARD E-Pay application is accessible from both the Preliminary and Final Renewal Statements and the FINRA (www.finra.org/crd) or IARD (www.iard.com) websites. This application allows a firm to make an electronic payment from a designated bank account to the firm's Renewal Account with FINRA. Please note that in order for funds to post to your firm's Renewal Account by December 13, 2010, submit payment electronically no later than **8 p.m., ET, on December 9, 2010**.

Check

The check must be drawn on the firm's account and include the firm's CRD number and "Renewal" in the memo line. Firms paying by check should account for U.S. mail delivery and payment processing time. To ensure prompt processing of your renewal payment check:

- Include a print-out of the first page of your Preliminary Renewal Statement with payment.
- **Do not** include any other forms or fee submissions.
- Make the check payable to FINRA. Write your firm's CRD number and "Renewal" on the check memo line.
- Send payment in the blue, pre-addressed renewal payment envelope mailed to your firm in early November or write the address on an envelope exactly as noted in this *Notice*:

U.S. Mail

FINRA
P.O. Box 7777-8705
Philadelphia, PA 19175-8705

(Note: This box will not accept courier or overnight deliveries.)

Overnight or Express Delivery

FINRA
8705
Mellon Bank Room 3490
701 Market Street
Philadelphia, PA 19106

Telephone: (301) 869-6699

Please Note: The addresses for renewal payments are different from the addresses for funding firms' Web CRD/IARD Daily Accounts.

Wire Payment

Firms may wire full payment of their Preliminary Renewal Statements by requesting their banks to initiate wire transfers to: "**Mellon Financial, Philadelphia, PA.**" Firms should provide their banks with the following information:

Transfer funds to: **Mellon Financial, Philadelphia, PA**

ABA Number: **031 000 037**

Beneficiary: **FINRA**

FINRA Account Number: **8-234-353**

Reference Number: **Firm CRD number and "Renewal"**

To ensure prompt processing of a renewal payment by wire transfer, remember to:

- Inform the bank to credit funds to the **FINRA bank account**.
- Provide the firm's CRD number and "Renewal" as reference only.
- Record the confirmation number of the wire transfer provided by the bank.

Renewal Reports

Beginning November 15, 2010, firms can request, print and/or download renewal reports via Web CRD/IARD. Three reports are available for reconciliation with the Preliminary Renewal Statement:

- **Firm Renewal Report**—lists individuals included in the Renewal Program and includes billing codes (if they have been supplied by the firm).
- **Branches Renewal Report**—lists each branch registered with FINRA and/or with any other regulator that renews branches registered with the regulator through Web CRD/IARD and for which the firm is being assessed a fee. Firms should use this report to reconcile their records for renewal purposes.
- **Approved AG Reg Without FINRA Approval Report**—contains all individuals who are not registered with FINRA, but are registered with one or more jurisdictions. Firms should request this report as soon as possible to determine if it needs to request any FINRA registrations or terminate jurisdiction registrations.

Post-Dated Form Filings

This functionality allows firms to file termination forms with a termination date of December 31, 2010. If a Form U5, BDW, BR Closing/Withdrawal or ADV-W filing indicates a termination date of December 31, 2010, an agent (AG), investment adviser representative, broker-dealer and/or investment adviser (firm) and the branch may continue doing business in that jurisdiction until the end of the calendar year without being assessed 2011 renewal fees. **December 31, 2010, is the only date allowed for a post-dated form filing.**

Firms can begin filing post-dated Form U5 and BR Closing/Withdrawal filings via Web CRD/IARD on October 25, 2010. In addition, firms can begin filing post-dated Form BDW and ADV-W filings via Web CRD/IARD on November 1, 2010. Firms that submit post-dated termination filings by 11 p.m., ET, on November 12, 2010, **will not** be assessed renewal fees for the terminated registrations on their Preliminary Renewal Statements. Firms that submit post-dated termination filings on, or after, November 15, 2010, will not be assessed renewal fees for the terminated jurisdictions on their Final Renewal

Statements in January 2011. Those firms should see a credit balance on their Final Renewal Statements if the firm has not requested additional registrations during that time period to offset the credit balance.

After submitting any termination filing, firms should query individual, branch and/or firm registrations to ensure that Form U5, BDW, BR Closing/Withdrawal and ADV-W filings process by the renewal filing deadline date of 6 p.m., ET, on December 23, 2010.

Firms should exercise care when submitting all post-dated filings. Web CRD/IARD processes these forms as firms submit and FINRA cannot withdraw a post-dated termination filing once submitted. A firm that submits a post-dated termination filing in error will have to file a new Form U4, BD, Form BR or Form ADV when Web CRD/IARD resumes normal processing on January 3, 2011, and Web CRD/IARD will assess new registration fees as a result.

Filing Form BDW

The CRD Phase II Program allows firms requesting broker-dealer termination (either full or partial) to file their Forms BDW via Web CRD. Firms that file either a full or partial Form BDW by 11 p.m., ET, November 12, 2010, avoid the assessment of the applicable renewal fees on their Preliminary Renewal Statements, provided that the regulator is a CRD Phase II participant. Currently, only five regulators participate in Web CRD renewals for agent fees, but **do not** participate in CRD Phase II:

- American Stock Exchange
- Chicago Stock Exchange
- National Stock Exchange
- NYSE Arca, Inc.
- Philadelphia Stock Exchange

Firms requesting termination with any of those five regulators must submit a paper Form BDW directly to that regulator, as well as submit one electronically via Web CRD.

The deadline for electronic filing of a Form BDW for any firm that wants to terminate a registration before year-end is 6 p.m., ET, December 23, 2010. This same date applies to the filing of any Form BDW with regulators that are not Phase II participants.

Filing Forms ADV to Cancel Notice Filings or Forms ADV-W to Terminate Registrations

Firms that file either a Form ADV Amendment, unmarking a state (generating the status of “Removal Requested at End of Year”) or a Form ADV-W by 11 p.m., ET, November 12, 2010, avoid the assessment of applicable renewal fees on their Preliminary Renewal Statements. The deadline to file Form ADV Amendments or Form ADV-W for firms that want to cancel a notice filing or terminate a state registration before year-end is 6 p.m., ET, December 23, 2010.

Removing Open Registrations

Throughout the year, firms have access to the “Approved AG Reg Without FINRA Approval Report” via Web CRD. This report identifies agents with an approved jurisdiction registration but who do not have an approved FINRA registration. Firms should use this report to terminate obsolete jurisdiction registrations through the submission of a Form U5 or reinstate the FINRA positions through the filing of a Form U4 Amendment. Firms should request this report as soon as possible so they can identify individuals to terminate by November 12, 2010, to avoid renewal charges for those individuals on their Preliminary Renewal Statements. This report also advises the firm if there are no agents at the firm within this category.

Final Renewal Statements

On January 3, 2011, FINRA makes available all Final Renewal Statements on Web CRD/IARD. These statements reflect the status of broker-dealer, registered representative (AG), investment adviser firm and investment adviser representative (RA) registrations and/or notice filings as of December 31, 2010. Any adjustments in fees owed resulting from registration terminations, approvals, notice filings or transitions after the Preliminary Renewal Statement appear on the Final Renewal Statement in Web CRD/IARD.

- Web CRD/IARD reflects an amount owed if a firm has more individuals, branch offices or jurisdictions registered and/or notice filed on Web CRD/IARD at year-end than it did when the Preliminary Renewal Statement generated.
- Web CRD/IARD issues a refund if a firm has fewer individuals, branch offices or jurisdictions registered or notice filed at year-end than it did on the Preliminary Renewal Statement. Note that FINRA transfers overpayments to the firms' Daily Accounts on January 3, 2011. Firms that have a credit balance in their Daily Accounts may submit a written and signed refund request by mail to: FINRA, Finance Department, 9509 Key West Avenue, Rockville, MD 20850; or by fax to: (240) 386-5344. The request should include a print-out of the firm's credit balance as reflected on Web CRD/IARD.

On or after January 3, 2011, FINRA member firms and joint BD/IA firms should access the Web CRD reports functionality for the **Firm Renewal Report**, which will list all individuals renewed with FINRA, AMEX, ARCA, BATS-YX, BATS-ZX, BX, CBOE, CHX, ISE, NOX, NYSE, PHLX and each jurisdiction. Agents and RAs whose registrations are “approved” in any of these jurisdictions during November and December will be included in this roster. “Pending” and “deficient” registrations at year’s end are not included in the Renewal Program. Firms will also be able to request the **Branches Renewal Report** that lists all branches for which they have been assessed renewal fees. Versions of these reports will also be available for download.

Firms have until **February 4, 2011**, to report any discrepancies on the renewal reports. This is also the **deadline for receipt of final payment**. Specific information and instructions concerning the Final Renewal Statement and renewal reports will be available in a January 2011 *Regulatory Notice*.

Encryption of Rule 8210 Information

SEC Approves Amendments to FINRA Rule 8210 to Require Encryption of Information Provided Via Portable Media Device

Effective Date: December 29, 2010

Executive Summary

Beginning December 29, 2010, information provided via a portable media device in response to requests under FINRA Rule 8210 must be encrypted.

The text of FINRA Rule 8210, as amended, is set forth in Attachment A.

Questions regarding this *Notice* should be directed to:

- ▶ Emily Gordy, Senior Vice President and Director Of Policy, Enforcement, at (202) 974-2916;
- ▶ Laurie Dzien, Chief Privacy Officer and Associate General Counsel, Data Privacy & Protection, Office of General Counsel (OGC), at (240) 386-6339; or
- ▶ Stan Macel, Assistant General Counsel, OGC, at (202) 728-8056.

Background and Discussion

The SEC recently approved amendments to FINRA Rule 8210 (Provision of Information and Testimony and Inspection and Copying of Books) that require information provided via a portable media device pursuant to a request under the rule be encrypted, as described in more detail below.¹ These amendments take effect on December 29, 2010.

FINRA Rule 8210 confers on FINRA staff the authority to compel a member firm, person associated with a member firm or other person over which FINRA has jurisdiction, to produce documents, provide testimony or supply

November 2010

Notice Type

- ▶ Rule Amendment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Senior Management

Key Topics

- ▶ Encryption
- ▶ Investigations

Referenced Rules & Notices

- ▶ FINRA Rule 8210

written responses or electronic data in connection with an investigation, complaint, examination or adjudicatory proceeding.² FINRA Rule 8210(c) provides that a firm's or person's failure to provide information or testimony or to permit an inspection and copying of books, records or accounts is a violation of the rule.

Frequently, member firms and persons that respond to requests pursuant to FINRA Rule 8210 provide information in electronic format. Because of the size of the electronic files, often this information is provided in electronic format using a portable media device such as a CD-ROM, DVD or portable hard drive.³ In many instances, the response contains personal information that, if accessed by an unauthorized person, could be used inappropriately.⁴

Data security issues regarding personal information have become increasingly important in recent years.⁵ In this regard, FINRA believes that requiring persons to encrypt information on portable media devices provided to FINRA in response to Rule 8210 requests will help ensure that personal information is protected from improper use by unauthorized third parties.

As amended, the rule requires that when information responsive to a request pursuant to Rule 8210 is provided on a portable media device, it must be "encrypted"—*i.e.*, the data must be encoded into a form in which meaning cannot be assigned without the use of a confidential process or key. To help ensure that encrypted information is secure, persons providing encrypted information to FINRA via a portable media device are required:

- (1) to use an encryption method that meets industry standards for strong encryption; and
- (2) to provide FINRA staff with the confidential process or key regarding the encryption in a communication separate from the encrypted information itself (*e.g.*, a separate email, fax or letter).

Currently, FINRA views industry standards for strong encryption to be 256-bit or higher encryption. Encryption software meeting this standard is widely available as embedded options in desktop applications and through various vendors via the Internet at no cost or minimal cost to the user.

Endnotes

- 1 See Exchange Act Release No. 63016 (Sept. 29, 2010), 75 FR 61793 (Oct. 6, 2010) (Order Approving Proposed Rule Change; File No. SR-FINRA-2010-021).
- 2 The rule applies to all member firms, associated persons and other persons over which FINRA has jurisdiction, including former associated persons subject to FINRA's jurisdiction as described in the FINRA By-Laws. See FINRA By-Laws, Article V, Section 4(a) (Retention of Jurisdiction).
- 3 The amended rule defines "portable media device" as a storage device for electronic information, including but not limited to a flash drive, CD-ROM, DVD, portable hard drive, laptop computer, disc, diskette or any other portable device for storing and transporting electronic information.
- 4 For example, a response may include a person's first and last name, or first initial and last name, in combination with that person's: (1) social security number; (2) driver's license, passport or government-issued identification number; or (3) financial account number (including, but not limited to, number of a brokerage account, debit card, credit card, checking account or savings account).
- 5 For example, some jurisdictions, including Massachusetts and Nevada, have recently enacted legislation that establishes minimum standards to safeguard personal information in electronic records. See, e.g., Commonwealth of Massachusetts, 201 CMR 17.00 (Standards for the Protection of Personal Information of Residents of the Commonwealth), effective March 1, 2010; State of Nevada, NRS 603A.215 (Security Measures for Data Collector that Accepts Payment Card; Use of Encryption; Liability for Damages; Applicability), effective January 1, 2010. These laws contain potential penalties against persons and entities for failures to adequately safeguard electronic information containing personal information.

ATTACHMENT A

New language is underlined.

* * * * *

8200. INVESTIGATIONS

8210. Provision of Information and Testimony and Inspection and Copying of Books

(a) through (f) No Change.

(g) Encryption of Information Provided in Electronic Form

(1) Any member or person who, in response to a request pursuant to this Rule, provides the requested information on a portable media device must ensure that such information is encrypted.

(2) For purposes of this Rule, a “portable media device” is a storage device for electronic information, including but not limited to a flash drive, CD-ROM, DVD, portable hard drive, laptop computer, disc, diskette, or any other portable device for storing and transporting electronic information.

(3) For purposes of this Rule, “encrypted” means the transformation of data into a form in which meaning cannot be assigned without the use of a confidential process or key. To ensure that encrypted information is secure, a member or person providing encrypted information to FINRA staff pursuant to this Rule shall (a) use an encryption method that meets industry standards for strong encryption, and (b) provide the confidential process or key regarding the encryption to FINRA staff in a communication separate from the encrypted information itself.

Approval of New Issue Rule

SEC Approves New FINRA Rule to Address Abuses in the Allocation and Distribution of New Issues

Effective Date: May 27, 2011

Executive Summary

New FINRA Rule 5131 (New Issue Allocations and Distributions), which further and more specifically prohibits certain abuses in the allocation and distribution of new issues¹ goes into effect on May 27, 2011. Among other things, the rule prohibits *quid pro quo* allocations and “spinning,” and addresses the conduct of member firms and associated persons in the areas of book-building, new issue pricing, penalty bids, trading and waivers of lock-up agreements.

The text of the amendments can be found in the online *FINRA Manual* at www.finra.org/finramanual.

Questions regarding this *Notice* should be directed to:

- Gary L. Goldsholle, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8104; or
- Racquel L. Russell, Assistant General Counsel, OGC, at (202) 728-8363.

Background and Discussion

New FINRA Rule 5131 is intended to sustain public confidence in the initial public offering (IPO) process by establishing specific and detailed regulatory requirements with respect to the allocation, pricing and trading of new issues. Rule 5131 implements many of the recommendations made by the NYSE/NASD IPO Advisory Committee for improving the integrity of the IPO process.²

November 2010

Notice Type

- New Rule

Suggested Routing

- Compliance
- Corporate Financing
- Legal
- Operations
- Senior Management
- Syndicate
- Underwriting

Key Topics

- Allocations
- Conflicts of Interest
- Flipping
- Initial Public Offerings
- Investment Banking
- Issuer-Directed Securities
- New Issues
- Public Offerings
- Quid Pro Quo
- Returned Shares
- Spinning

Referenced Rules

- FINRA Rule 5130
- FINRA Rule 5131
- SEC Regulation FD
- SEC Regulation M

Rule 5131 incorporates the definition of “new issue” from Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings). FINRA believes that this definition, with its enumerated exceptions, addresses the types of IPOs for which the protections of the rule are most appropriate. The term “new issue” refers to “an initial public offering of an equity security as defined in Section 3(a)(11) of the Exchange Act, made pursuant to a registration statement or offering circular.”³

Prohibition on Abusive Allocation Arrangements

Paragraph (a) of Rule 5131 (Quid Pro Quo Allocations) prohibits a member firm from using an allocation of a new issue as a means of obtaining a “kick back” from the recipient in the form of excessive compensation for other services offered by the member. Specifically, the new provision provides that no member or person associated with a member may offer or threaten to withhold shares it allocates of a new issue as consideration or inducement for the receipt of compensation that is excessive in relation to the services provided by the member.

This provision prohibits so-called *quid pro quo* activity, not only with respect to trading services, but any service offered by the member.⁴ An assessment of whether compensation is excessive will be based upon all 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

Spinning

Paragraph (b) of Rule 5131 (Spinning) prohibits allocations of new issues to executive officers and directors of current, and certain former or prospective, investment banking clients. Because such persons are often in a position to hire members on behalf of the companies they serve, allocating new issues to such persons creates the appearance of impropriety and has the potential to divide the loyalty of the agents of the company (*i.e.*, the executive officers and directors) from the principal (*i.e.*, the company) on whose behalf they must act.

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.

The spinning prohibition also provides, as a prophylactic measure, that no member or person associated with a member may allocate shares of a new issue to any account in which an executive officer or director of a public company or a “covered non-public company,”⁶ or a person materially supported by such executive officer or director, has a beneficial interest:

- if the company is currently an investment banking services client of the member or the member has received compensation from the company for investment banking services in the past 12 months;
- if 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 three months;⁷ or
- on the express or implied condition that such executive officer or director, on behalf of the company, will retain the member for the performance of future investment banking services.

To facilitate compliance with the spinning prohibition, Supplementary Material .02 permits members to rely on written representations obtained within the prior 12 months from the beneficial owner(s) of an 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 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.⁸

Supplementary Material .01 clarifies that the spinning prohibition does not apply to allocations directed in writing by the issuer, its affiliates or selling shareholders—so long as the member has no involvement or influence, directly or indirectly, in the allocation decisions of the issuer, its affiliates or selling shareholders with respect to such issuer-directed allocations.

Finally, the spinning prohibition excepts allocations of new issues to certain types of accounts—generally consistent with the types of accounts excepted from the restrictions imposed by Rule 5130.⁹ The one area of divergence between the exceptions in Rules 5130 and 5131 pertains to accounts in which multiple persons have a beneficial interest. Paragraph (b)(3) permits allocations of new issues to an account in which the collective 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 percent of such account.¹⁰

Flipping

The term “flipping” refers to the practice of selling new issues into the secondary market at a profit within 30 days following the offering date. Because these sales create downward pressure on the secondary market trading price, underwriters and selling group members may seek to discourage such sales. Under most syndicate selling agreements, a managing underwriter is permitted to impose a “penalty bid” on syndicate members to reclaim the selling concession for allocations that were flipped.

Separately, and independent of any syndicate penalty bid, some firms have sought to recoup selling concessions from particular brokers when their customers—typically retail customers—flip a new issue. The incentives created by linking a broker’s compensation to whether or not a customer holds onto a particular security position has the potential of favoring institutional investors at the expense of retail customers.

Accordingly, paragraph (c) of Rule 5131 prohibits any member or person associated with a member from directly or indirectly recouping, or attempting to recoup, any portion of a commission or credit paid or awarded to an associated person for selling shares of a new issue that are subsequently flipped by a customer, unless the managing underwriter has assessed a penalty bid on the entire syndicate.¹¹ FINRA believes that it is only appropriate for a firm to recoup a particular broker’s compensation for selling a new issue in connection with a customer’s decision to flip a security when the firm itself is required to forfeit its compensation to the managing underwriter(s).

Reports of Indications of Interest and Final Allocations

Paragraph (d)(1) of Rule 5131 seeks to provide issuers and their pricing committees with greater transparency into the book-building process by mandating certain disclosures about the demand for the issuer’s securities. In particular, paragraph (d)(1) requires that, in connection with a new issue, the book-running lead manager provide the issuer’s pricing committee (or, if the issuer has no pricing committee, its board of directors) with:

- (a) a regular report of indications of interest, including the names of interested institutional investors and the number of shares indicated by each, as reflected in the book-running lead manager’s book of potential institutional orders, and a report of aggregate demand from retail investors; and
- (b) after the settlement date of the new issue, a report of the final allocation of shares to institutional investors as reflected in the books and records of the book-running lead manager, including the names of purchasers and the number of shares purchased by each, and aggregate sales to retail investors.

Lock-Up Agreements

The existence of lock-ups or other restrictions on the transfer of the issuer's shares by officers and directors of the issuer is often an important factor for investors in an IPO. Paragraph (d)(2) helps ensure the broad and consistent application of lock-ups by requiring that any lock-up agreement or other restriction on the transfer of the issuer's shares by officers and directors of the issuer is applied consistently to include their issuer-directed shares.

Moreover, given the importance of lock-ups for investors, FINRA believes that underwriters should not be permitted to waive certain lock-up restrictions without providing prior notice to market participants. Paragraph (d)(2) requires that any lock-up agreement applicable to the officers and directors of the issuer stipulate that, at least two business days before the release or waiver of any lock-up or other restriction on the transfer of the issuer's shares, the book-running lead manager must notify the issuer of the impending release or waiver and announce the impending release or waiver through a major news service,¹² except where the release or waiver is effected solely to permit a transfer of securities that is not for consideration and where the transferee has agreed in writing to be bound by the same lock-up agreement terms in place for the transferor.¹³

Supplementary Material .03 further clarifies that the requirement that the book-running lead manager announce the impending release or waiver of a lock-up or other restriction on the transfer of the issuer's shares is satisfied where the announcement is made by the book-running lead manager, another member or the issuer—so long as such announcement otherwise complies with the requirements of paragraph (d)(2).

Agreement Among Underwriters

Occasionally, shares in a new issue allocated to a customer will be returned to the syndicate member. If the new issue shares are trading at a premium to the IPO price, the syndicate member reallocating such shares would be able to confer an almost instantaneous and risk-free profit. To prevent this occurrence, paragraph (d)(3) requires that the agreement between the book-running lead manager and other syndicate members require, to the extent not inconsistent with SEC Regulation M, that any shares trading at a premium to the public offering price that are returned to a syndicate member after secondary market trading commences:

- be used to offset the existing syndicate short position; or
- if no syndicate short position exists, the member must either:
 - 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

New issues are inherently more volatile than securities with an established public trading history. Given the absence of an established trading market, the potential exists for a wide variance between the public offering price of a new issue and the price at which trading on the secondary market commences. As a result, investors who place market orders for an IPO may find their orders filled at prices beyond their reasonable expectations, and such transactions may further contribute to the unconstrained increase in the price of a new issue in the secondary market.

To protect against this occurrence, paragraph (d)(4) of Rule 5131 prohibits members from accepting 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. FINRA believes that requiring investors to place limit orders prior to the commencement of trading will serve the dual purposes of protecting investors and facilitating price discovery.

New Rule 5131 becomes effective May 27, 2011. For more information, go to www.finra.org to see rule filing SR-NASD-2003-140.

Endnotes

- 1 See Securities Exchange Act Release No. 63010 (September 29, 2010); 75 FR 61541 (October 5, 2010) (Order Approving SR-NASD-2003-140).
- 2 In 2002, the SEC requested that FINRA (then NASD) and NYSE convene a special IPO Advisory Committee to “review the IPO underwriting process, particularly price setting and allocation practices, in light of recent experience, and to recommend to the securities industry community such changes as may be necessary to address the problems that have been observed.”
- 3 The definition of “new issue” contains a series of exceptions. See Rule 5130(i)(9)(A)-(J).
- 4 FINRA does not intend that this prohibition interfere with legitimate customer relationships. For example, this provision is not intended to prohibit a member from allocating new issue shares to a customer because the customer has separately retained the member for other services, when the customer has not paid excessive compensation in relation to those services.
- 5 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.
- 6 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.
- 7 If an executive officer or director receives an allocation and the allocating member is subsequently retained by such executive officer or director’s employing firm to perform investment banking services within the three-month window, FINRA will investigate the particular information about the business relationship that was known (and by whom) at the time of the allocation, including a review of the communications between the broker-dealer and the investment banking client, and between the investment banking and syndicate departments, as well as the member’s systems for logging and managing prospective and current client and transaction information.
- 8 Members and associated persons are reminded that they may not rely upon any representation they believe, or have reason to believe, is inaccurate. Additionally, members are required 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 firm’s allocation to that account.

Endnotes

- 9 The prohibitions of the spinning provision do not apply to allocations of shares of a new issue to any account described in paragraphs (c)(1) through (3) and (5) through (10) of Rule 5130, 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 percent of such account.
- 10 Under Rule 5130(b)(4), the aggregate beneficial interests of restricted persons must not exceed 10 percent of such account.
- 11 In addition to any obligation to maintain records relating to penalty bids under SEA Rule 17a-2(c)(1), a member must promptly record and maintain information regarding any penalties or disincentives assessed on its associated persons in connection with a penalty bid.
- 12 Any news service used by issuers for providing public disclosure of material information pursuant to SEC Regulation FD would satisfy the rule's requirement that public disclosure be made "through a major news service." However, also as required pursuant to Regulation FD, it is important that members utilize a method (or combination of methods) of disclosure 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 method that is likely to result in the actual public dissemination of the specified information. FINRA also would consider disclosure of a release or wavier in a publicly filed registration statement in connection with a secondary offering as satisfying the requirement for an announcement through a major news service.
- 13 Notice and public disclosure is not necessary for the natural expiration of a lock-up already disclosed in the prospectus.