

Regulatory Notice

07-34

“New Issue” Rule

SEC Approves Amendments Relating to the Issuer-Directed Provisions of Rule 2790

Effective Date: September 5, 2007

Executive Summary

On June 7, 2007, the SEC approved amendments to Rule 2790 to prohibit issuer-directed allocations of new issues to broker-dealers and to provide an exemption for issuer-directed non-underwritten offerings.¹ The Rule, as amended, is set forth in Attachment A of this *Notice*. The amendments become effective on **September 5, 2007**.

Questions/Further Information

Questions concerning this *Notice* may be directed to Gary L. Goldsholle, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8104; or Afshin Atabaki, Assistant General Counsel, OGC, at (202) 728-8902.

Background and Discussion

Rule 2790 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) protects the integrity of the public offering process by ensuring that:

- (1) member firms make *bona fide* public offerings of securities at the offering price;
- (2) member firms do not withhold securities in a public offering for their own benefit or use such securities to reward persons who are in a position to direct future business to member firms; and
- (3) industry insiders, including member firms and their associated persons, do not take advantage of their insider position to purchase new issues for their own benefit at the expense of public customers.

August 2007

Notice Type

- Rule Amendment

Suggested Routing

- Compliance
- Corporate Financing
- Executive Representatives
- Institutional
- Legal
- Operations
- Senior Management
- Syndicate
- Trading
- Market Making
- Training
- Underwriting

Key Topic(s)

- IPOs
- Issuer-Directed Securities
- “New Issue” Rule
- Rule 2790

Referenced Rules & Notices

- Rule 2790
- NTM 03-79
- “New Issue” Rule

Rule 2790 provides that, except as otherwise permitted under the Rule, a firm (or an associated person) may not sell a new issue to an account in which a restricted person has a beneficial interest; a member firm (or an associated person) may not purchase a new issue in any account in which such firm or associated person has a beneficial interest; and a firm may not continue to hold new issues acquired as an underwriter, selling group member, or otherwise.

FINRA has recognized that shares directed by an issuer do not raise the same regulatory concerns as shares allocated by a broker-dealer.² Moreover, shares directed by an issuer often further the legitimate business interests of the issuer.³ Accordingly, Rule 2790 exempts, for most purchasers, securities that are specifically directed by the issuer.⁴

Prohibition of Issuer-Directed Allocations to Broker-Dealers

Rule 2790(d)(1) generally exempts from the scope of the Rule allocations of new issue securities that are specifically directed by the issuer. However, for securities directed to an account in which broker-dealer personnel, finders or fiduciaries, or certain members of their immediate family have a beneficial interest,⁵ the exemption is only applicable if such persons, or members of their immediate family, are employees or directors of the issuer, the issuer's parent, or a subsidiary of the issuer or the issuer's parent. These additional conditions are designed to ensure that broker-dealer personnel, finders, fiduciaries and certain members of their immediate family, who typically have the greatest potential to influence the IPO allocation process, have a demonstrated basis for being selected by the issuer to purchase shares in the IPO.

FINRA is further limiting the exemption for issuer-directed securities in Rule 2790(d)(1) to exclude new issue securities directed to a broker-dealer. To the extent that broker-dealer personnel have a beneficial interest in the broker-dealer, the broker-dealer would already be subject to the limitations in Rule 2790(d)(1). However, the amendments establish a much more direct prohibition against purchases of new issues by broker-dealers, even if the securities are directed by the issuer.

Exemption for Issuer-Directed Non-Underwritten Offerings

In 2005, the staff received two requests for exemptive relief related to the issuer-directed exemption in Rule 2790(d)(1).⁶ Both requests came from banks that were eligible to offer their own securities pursuant to an exemption from registration under Section 3(a)(2) of the Securities Act of 1933. Both of these offerings were entirely on a non-underwritten basis, and all decisions regarding the allocation of shares in the offerings were determined at the sole discretion of the respective issuers. These issuers argued, and the staff agreed, that the heightened requirements of Rule 2790(d)(1) would impair their ability to attract capital and served no regulatory purpose in light of the fact that no broker-dealer was underwriting or otherwise involved in allocating any of the shares that were being offered. Further, Rule 2790 generally is predicated on a member firm's involvement in the allocation process. As such, the staff granted an exemption from Rule 2790 in connection with both offerings.

FINRA has codified this position by adding new paragraph (d)(2) to Rule 2790, which provides that the prohibitions on the purchase and sale of new issues do not apply to securities that are specifically directed by the issuer to restricted persons, provided that a broker-dealer: (1) does not underwrite any portion of the offering; (2) does not solicit or sell any new issue securities in the offering; and (3) has no involvement or influence, directly or indirectly, in the issuer's allocation decisions with respect to any of the new issue securities in the offering.

New paragraph (d)(2) would not prevent an issuer from engaging a broker-dealer to provide advisory services (such as rendering advice regarding capital structure and capital raising) or other limited services, so long as the conditions set forth in paragraph (d)(2) continue to be satisfied. In addition, for purposes of compliance with new paragraph (d)(2), a member firm or associated person that wishes to purchase new issues in such offerings may rely on a written representation obtained in good faith from the issuer that the conditions in paragraph (d)(2) are satisfied. However, the firm or associated person may not rely upon any representation from the issuer that it believes, or has reason to believe, is inaccurate.

Endnotes

- 1 See Securities Exchange Act Release No. 55878 (June 7, 2007), 72 FR 32936 (June 14, 2007) (Order Approving Proposed Rule Change Relating to the Application of Rule 2790 to Issuer-Directed Securities; File No. SR-NASD-2006-074).
- 2 See *Notice to Members 03-79* (SEC Approves New Rule 2790 (Restrictions on the Purchase and Sale of IPOs of Equity Securities); Replaces Free-Riding and Withholding Interpretation) (December 2003).
- 3 *Id.*
- 4 The issuer-directed exemption is applicable only when shares are in fact directed by an issuer (that is, a member cannot seek to have an issuer direct securities to restricted persons on the member's behalf under the exemption).
- 5 The term broker-dealer personnel includes, among others, any officer, director, general partner, associated person, and employee of a broker-dealer, as well as certain immediate family members of such persons. The term finders and fiduciaries, with respect to the security being offered, includes a finder or any person acting in a fiduciary capacity to the managing underwriter, including, but not limited to, attorneys, accountants, and financial consultants, as well as certain immediate family members of such persons. See Rules 2790(i)(10)(B) and (i)(10)(C).
- 6 See Letter to Noel M. Gruber, Kennedy & Barris, LLP, from Afshin Atabaki, OGC, dated October 18, 2005 (available at: www.finra.org/RulesRegulation/PublicationsGuidance/ExemptiveLetters/P015421), and Letter to Bruce E. Lee from Afshin Atabaki, OGC, dated February 3, 2006 (available at: www.finra.org/RulesRegulation/PublicationsGuidance/ExemptiveLetters/P016098).

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Attachment A

Below is the text of the rule change. New language is underlined; deletions are in brackets.

2790. Restrictions on the Purchase and Sale of Initial Equity Public Offerings

(a) through (c) No Change.

(d) Issuer-Directed Securities

The prohibitions on the purchase and sale of new issues in this rule shall not apply to securities that:

(1) are specifically directed by the issuer to persons that are restricted under the rule; provided, however, that securities directed by an issuer may not be sold to or purchased by:

(A) a broker-dealer; or

(B) an account in which any restricted person specified in subparagraphs (i)(10)(B) or (i)(10)(C) of this rule has a beneficial interest, unless such person, or a member of his or her immediate family, is an employee or director of the issuer, the issuer's parent, or a subsidiary of the issuer or the issuer's parent. Also, for purposes of this paragraph (d)(1) only, a parent/ subsidiary relationship is established if the parent has the right to vote 50% or more of a class of voting security of the subsidiary, or has the power to sell or direct 50% or more of a class of voting security of the subsidiary;

(2) are specifically directed by the issuer and are part of an offering in which no broker-dealer:

(A) underwrites any portion of the offering;

(B) solicits or sells any new issue securities in the offering; and

(C) has any involvement or influence, directly or indirectly, in the issuer's allocation decisions with respect to any of the new issue securities in the offering;

~~(3)~~ [(2)] are part of a program sponsored by the issuer or an affiliate of the issuer that meets the following criteria:

(A) the opportunity to purchase a new issue under the program is offered to at least 10,000 participants;

(B) every participant is offered an opportunity to purchase an equivalent number of shares, or will receive a specified number of shares under a predetermined formula applied uniformly across all participants;

(C) if not all participants receive shares under the program, the selection of the participants eligible to purchase shares is based upon a random or other non-discretionary allocation method; and

(D) the class of participants does not contain a disproportionate number of restricted persons as compared to the investing public generally; or

~~(4)~~ [(3)] are directed to eligible purchasers who are otherwise restricted under the rule as part of a conversion offering in accordance with the standards of the governmental agency or instrumentality having authority to regulate such conversion offering.

(e) through (j) No Change.