Regulatory Notice 10-60

November 2010

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 issues[1] 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]

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

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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.

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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.

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