Client Alert

Chapman and Cutler LLP
Attorneys at Law · Focused on Finance®

CURRENT ISSUES RELEVANT TO OUR CLIENTS DECEMBER 7, 2010

SEC Approves FINRA New Issue Allocation and Distribution Rule

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently issued Regulatory Notice 10-60 (the "Notice") to alert member firms that the Securities and Exchange Commission ("SEC") has approved new FINRA Rule 5131 (New Issue Allocations and Distributions), which will be effective as of May 27, 2011. Among other things, FINRA Rule 5131 prohibits quid pro quo and "spinning" allocations of new issues of securities and addresses the book-building, new issue pricing, penalty bids, trading, and waivers of lock-up agreements by member firms and associated persons. The full text of the Notice is located at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122490.pdf. The text of the rule amendments is located in the online FINRA Manual at http://www.finra.org/finramanual.

Background

In 2002, the SEC requested that FINRA and the New York Stock Exchange convene a special advisory committee to review the initial public offering ("IPO") underwriting process, particularly the practices of price setting and allocation of shares. The committee was asked to recommend changes to the securities industry to address problems that the SEC observed. New FINRA Rule 5131 implements many of the recommendations made by the committee with the intent to sustain public confidence in the IPO process by establishing specific and detailed regulatory requirements with respect to the allocation, pricing, and trading of new issues. Note that this rule is distinct from the FINRA "new issue" rule (FINRA Rule 5130) and addresses different issues.

"New Issue" Definition

FINRA Rule 5131 incorporates the definition of "new issue" from FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings). FINRA believes that this definition, with its several exceptions (as enumerated in FINRA Rule 5130(i)(9)), addresses the types of IPOs for which the protections of the rule are most appropriate. The term "new issue" generally refers to any initial public offering of an equity security (as defined in Section 3(a)(11) of the Securities Exchange Act of 1934, as amended) made pursuant to a registration statement or offering circular, subject to certain exclusions, such as convertible and preferred securities, registered investment company securities, and real estate investment trusts.

Prohibition on Quid Pro Quo Allocations

FINRA Rule 5131 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 prohibition of quid pro quo activity applies not only with respect to

Attorney Advertising Material.

trading services, but any service offered by the member. The prohibition does not, however, restrict allocations of new issues to a customer where the customer has legitimately and separately retained the member for other services, so long as the customer has not paid excessive compensation in relation to those services. 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. For example, trading activity that serves no economic purpose other than to generate compensation for the member would be considered excessive.

Prohibition on Spinning

FINRA Rule 5131 also 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, FINRA believes that 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. This “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, direct or indirect, in the new issue allocation decisions of the member.

Pursuant to the spinning prohibition, 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” (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; 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.

The Notice states that if an executive officer or director receives a new issue allocation and the allocating member is subsequently retained by such executive officer or director’s employing firm to perform investment banking services within a 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. Such investigation may include 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.

New 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, direct or indirect, in the allocation decisions of the issuer, its affiliates, or selling shareholders with respect to such issuer-directed allocations.

To facilitate compliance, new Supplementary Material .02 permits members to rely on written representations obtained within the prior 12 months from the beneficial owner(s) of an account as to whether such beneficial owner 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.

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 FINRA Rule 5130. There is one area of divergence between the exceptions, which pertains to accounts in which multiple persons have a beneficial interest. FINRA Rule 5131 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, whereas the aggregate beneficial interests may not exceed 10 percent under FINRA Rule 5130.

Policies Concerning Flipping

The practice of selling new issues into the secondary market at a profit within 30 days following the offering date is generally referred to as "flipping." Because such sales may create downward pressure on the secondary market trading price, underwriters and selling group members are likely to discourage such sales. Many syndicate selling agreements provide that 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. FINRA believes that 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.

FINRA 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. 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).

Indications of Interest and Final Allocations

FINRA Rule 5131 mandates certain disclosures about the demand for the issuer's securities. In particular, in connection with a new issue, the book-running lead manager must provide the issuer's pricing committee (or, if the issuer has no pricing committee, its board of directors) with:

- 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
- 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.

FINRA believes that these requirements will provide issuers and their pricing committees with greater transparency into the book-building process.

Lock-Up Agreements

The existence of lock-ups or other restrictions on the transfer of an issuer's shares by officers and directors of the issuer is often an important factor for investors in an IPO. FINRA Rule 5131 requires 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.

FINRA believes that given the importance of lock-ups for investors, underwriters should not be permitted to waive certain lock-up restrictions without providing prior notice to market participants. FINRA Rule 5131 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, 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. 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, the Notice reminds members that, as required pursuant to Regulation FD, methods of disclosure must be reasonably designed to provide broad, non-exclusionary distribution of the required information to the public. As a result, 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. The Notice states that FINRA would also 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.

New Supplementary Material .03 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 the rule.

Agreement Among Underwriters

Newly issued shares allocated to a customer are occasionally returned to the syndicate member whereupon, if the new issue shares are trading at a premium to the IPO price, the syndicate member reallocating such shares may enjoy an almost instantaneous and risk-free profit. To prevent this occurrence, FINRA Rule 5131 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 (i) offer returned shares at the public offering price to unfilled customers' orders pursuant to a random allocation methodology, or (ii) 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

Because newly issued securities lack a relatively 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, FINRA 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.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Corporate and Securities Group or visit us online at chapman.com.

This document has been prepared by Chapman and Cutler LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.

© Chapman and Cutler LLP, 2010. All Rights Reserved