

SLF Alert

→ FINRA Promulgates the New Issue (IPO) Allocation Rule

→ The rule imposes compliance measures on Investment Funds to take effect May 27, 2011.

FINRA: New Issue (IPO) Allocation Rule

by, Sheheryar T. Sardar, Esq., Partner

On November 29, 2010, FINRA announced in Regulatory Notice 10-60 that FINRA Rule 5131 regulating new issue allocations and distributions will take effect on May 27, 2011. The Rule was first proposed by the NASD in 2002, was amended and reissued by the NASD in 2003 and 2004, and again in 2010. The SEC approved it on September 29, 2010.

After much debate and proposals, FINRA has promulgated Rule 5131 ("5131"), which imposes on certain investment funds several material compliance and disclosure requirements. It focuses on curbing potential abuses in the allocation and distribution of securities in IPOs. While existing securities laws already regulate FINRA members' actions with respect to IPOs, including SEC Rule 10b-5, SEC Regulation M, and FINRA Rule 5130, 5131 provides for additional restrictions. Specifically, 5131 regulates the following activities:

- Spinning
- Quid pro quo allocations;
- Flipping; and
- IPO pricing and trading practices.

**Spinning**

5131 has memorialized a general prohibition on the allocation by a FINRA member (essentially all SEC-registered broker-dealers) of new issues securities to any account in which an executive officer or director of a public or covered non-public company, has a beneficial interest, if:

- (1) the company is currently an investment banking client of the member; investment banking services;
- (2) in the 12-month period prior to the allocation, the member received compensation from the company for investment banking services;
- (3) the FINRA member expects to provide or be retained for investment banking services in the three month period following the allocation; or
- (4) such allocation is made on the condition that such executive officer or director, on behalf of the company, retain the member for performance of future investment banking services.

Spinning refers to the practice by specific underwriters of allocating "hot" IPO shares to directors and/or executives of potential investment banking clients in exchange for investment banking business. 5131(b)(1) illustrates and enforces the requirement that members establish 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 a member.

There are exceptions to 5131's spinning restrictions, largely regarding allocations of new issues to certain types of accounts. More specifically, in Amendment No. 4, FINRA narrowed the application of the spinning provision

March 2011

...cont'd by, Sheheryar T. Sardar

by limiting its application to accounts in which the following have a beneficial interest:

- 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 (each, a “restricted person”)

A “covered non-public company” is defined as any non-public company that satisfies any of the following three conditions:

- has 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;
- \$30 million worth of shareholders’ equity and a two-year operating history; or
- total assets and total revenue of at least \$75 million in the latest fiscal year or in two of the last three fiscal years.

The criterion is based on the quantitative initial listing standards of a national stock exchange. This is considered a suitable proxy for the types of companies likely to be targeted by investment bankers.

**Compliance:** The spinning prohibition enables compliance by allowing members to rely on written representations obtained within the prior 12 months from the beneficial owner(s) of an account as to (1) whether such beneficial owner(s) is an executive officer or director (or person materially supported by an executive officer or director), and (2) if so, the company or companies on whose behalf such executive officer or director serves.

The initial representation must be an affirmative representation, however, the use of negative consent letters may be used to update annually, so long as members not rely upon any representation that they believe, or have reason to believe, is inaccurate.

### **Flipping**

Flipping refers to initial sale of new issue shares purchased in an offering within 30 days following the relevant offering date. 5131 prohibits members or persons associated with members 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. The rule also requires that members record and maintain information regarding any penalties or disincentives assessed or its associated persons in connection with a penalty bid in addition to their existing requirements under the Exchange Act requirement to maintain records with respect to penalty bids.

### **New Issue Pricing and Trading Practices**

Rule 5131 requires that the book-running lead manager of a new issue provide detailed records regarding indications of interest and final allocations to the issuer’s pricing committee or board of directors. These records must include the names of interested institutional investors and the numbers of shares, in addition to a report of aggregate demand from retail investors. After the settlement date, the reports must include the

...cont'd by, Sheheryar T. Sardar

final allocation, including names of, and the amount of shares allocated to, institutional investors, and the aggregate sales to retail investors.

### ***Lock-Up Agreements and Other Restrictions***

Prior to Amendment No. 4, Rule 5131 provided that any release or waiver by underwriters of a lock-up agreement or other restriction on the transfer of shares must be preceded by notice to the issuer from the book-running lead manager and an announcement of the release or waiver in a major news service at least two business days in advance. FINRA clarifies that this requirement now applies only to a lock-up agreement or other restriction on the transfer of shares entered into in connection with a new issue. In addition, in new supplementary materials to Rule 5131, notice of an impending release or waiver may be announced by either the issuer or the applicable member or members. The supplementary materials expressly state, however, that the notice requirement remains the responsibility of the book-running lead manager of the new issue and such manager must ensure compliance with the notice requirement.

### ***Agreement among Underwriters***

Amendment No. 4 provides that agreements between the book-running lead manager and the other syndicate members must require that any shares trading at a premium to the public offering price that are returned by the purchaser after the commencement of secondary trading to (1) be used to offset the existing syndicate

short position or (2) if no syndicate short position exists, the member must either (a) offer returned shares at the public offering price to unfilled customers' orders pursuant to a random allocation methodology or (b) 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.

FINRA agreed to keep Amendment No. 4 by adding the ability to sell the shares on the open market.

### ***Market Orders***

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.

### ***Conclusion***

The changes set forth provide underwriters and market participants with additional compliance requirements. While many other rules and regulations have been adopted and achieve goals similar to Rule 5131, the fiscal crisis has initiated new regulations aimed at curbing conflicts of interest and protecting the investing public. Investment managers, hedge funds and underwriters should review their policies to ensure compliance.

For more information, please contact Sheheryar T. Sardar at [Sardar@sardarlawfirm.com](mailto:Sardar@sardarlawfirm.com).

*This information is not intended as legal advice. The issue discussed here is general and may not be applicable in all situations; it must not be taken as legal advice.*