Fixed Price Offerings

FINRA Proposes to Simplify Rules on Fixed Price Offerings

SUMMARY
On August 4, 2009, FINRA published Regulatory Notice 09-45 proposing to streamline FINRA’s rules governing fixed price offerings. The new Rule 5141 would replace three existing NASD rules governing fixed price offerings, Rules 2730, 2740 and 2750 (commonly known as the Papilsky Rules), and would continue the current general requirement that all sales of the offered securities to the public be made at the stated public offering price. The proposed Rule would continue the current exceptions for:

- Sales among syndicate and selling group members;
- The provision of research to purchasers of the offered securities if the research complies with the standards for research in Section 28(e) of the Exchange Act; and
- The purchase of securities taken in trade for the offered securities if the purchase is made at a “fair market price.”

The proposed Rule would add three new exceptions that would permit:

- Sales to affiliated entities at the stated public offering price in the ordinary course of business;
- The exclusion of securities sold to customers with investment advisory asset-based fee accounts from the calculation of the fee; and
- Payments to a FINRA member that is not participating in the offering so long as the payments do not result in a purchase of the offered securities by the member.

FINRA requests comments on the proposed Rule, which must be received by September 18, 2009.

BACKGROUND
NASD Rules 2730, 2740 and 2750 apply to any fixed price offering, defined as an offering of securities at a stated offering price or prices, all or part of which securities are publicly offered in the United States. The term “fixed price offering” is not limited to registered offerings and can include offerings of bank
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SECURITIES EXEMPT UNDER SECTION 3(a)(2) OF THE SECURITIES ACT OF 1933, BUT DOES NOT INCLUDE PRIVATE OFFERINGS OR OFFERINGS PURSUANT TO RULE 144A. RULES 2730, 2740 AND 2750 ARE COLLECTIVELY KNOWN AS THE “PAPILSKY RULES” BECAUSE OF THE COURT DECISION THAT CREATED UNCERTAINTY ABOUT PRIOR NASD INTERPRETATIONS IN THE AREA, LEAVING A VOID THAT THE NASD FILLED WITH THE PREDECESSORS TO THE THREE RULES.1

The Papilsky Rules are generally designed to require all sales in a fixed price offering to occur at the disclosed fixed price and to prohibit various techniques by which member firms participating in the distribution could sell securities to customers or other non-participants at a price below the fixed price or prices:2

- Rule 2740 prohibits a FINRA member from granting or receiving selling concessions, discounts or other allowances in connection with a fixed price offering except as consideration for services rendered in the distribution and from granting such concessions, discounts or other allowances to anyone other than a broker or dealer actually engaged in the investment banking or securities business.
- Rule 2730 prohibits a FINRA member engaged in a fixed price offering from purchasing or arranging the purchase of securities taken in trade from a customer as payment for securities purchased by the customer in the offering unless the securities taken in trade are purchased at a price no higher than their fair market price (since paying more would mean that the customer in effect purchased the offered securities at less than the fixed price).
- Rule 2750 prohibits a FINRA member from selling securities in a fixed price offering to a related person unless the member has made a bona fide public offering and has been unable to sell the securities at the public offering price.

PROPOSED RULE 5141

In Regulatory Notice 09-45,3 FINRA proposed to delete Rules 2730, 2740 and 2750 from the NASD rulebook and to replace them with FINRA Rule 5141 in the consolidated FINRA rulebook.

Rule 5141(a) would continue to prohibit FINRA members and persons associated with members that participate in a selling syndicate or selling group from selling securities in a fixed price offering at a “reduced price”. “Reduced price” would be defined to include any offer or grant of any selling concession, discount or allowance, credit, rebate, reduction of any fee (including any advisory or service fee) and any sale of products or services at prices below reasonable commercially available rates for similar products and services (except for research, discussed below). The definition of “reduced price” would permit the purchase of securities taken in trade from a customer at their “fair market price” (generally, a price or range of prices at which a willing buyer and a willing seller, each unrelated to the other, would purchase

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2 An offering may have more than one fixed price. For example, persons who purchase in large volumes (e.g., $100,000 or more) may pay a lower price per unit than persons who purchase in smaller volumes.

the securities in the ordinary course of business in transactions that are of similar size and similar characteristics and are independent of any other transaction).

Sales to Affiliated Persons
In a major change, the proposed Rule would permit sales by a member of a selling syndicate or selling group to an affiliated person in a fixed price offering so long as the sales are not made at a reduced price. The current rules prohibit such sales unless the member has made a bona fide public offering and is unable to sell the securities at the stated public offering price. Such sales would still be subject to the restrictions of Rule 5130 (the New Issue Rule) applicable to initial public offerings. The proposed Rule would exclude the value of other transactions between a member of a selling syndicate or selling group and an affiliated person that are part of the normal and ordinary course of business and are unrelated to the sale or purchase of securities in a fixed price offering from the reduced price calculation with respect to the securities sold to the affiliate.

Sales Within Syndicate or Selling Group
A member of a selling syndicate or selling group would be permitted to sell securities in a fixed price offering to other members of the selling syndicate or selling group, even if at a reduced price.

Payments to Non-Participating Members
The proposed Rule would permit payments to a FINRA member not participating in the syndicate or selling group for services rendered in connection with the offering, provided that the payments do not result in the purchase of the offered securities by the non-participating member at a reduced price. These payments are currently permitted under a FINRA interpretive letter. That letter effectively waived, and the proposed Rule would eliminate, the requirement in the current rule that these payments be made only for services rendered in distribution of the offered securities.

Free Research
If a FINRA member provides free research to a customer who purchases securities in a fixed price offering, the member could be viewed as providing products or services at prices below reasonable commercially available rates, resulting in a reduced price for the securities purchased by the customer. However, the proposed Rule would permit the member to provide free research to the person or account purchasing securities if the research conforms with the requirements of Section 28(e) of the Exchange Act and related SEC guidance. This would preserve an exception currently available in Rule 2740. Investment management and investment discretionary services are specifically stated not to be research for purposes of the proposed exception.

Asset-Based Fee Calculation
Under the proposed Rule, a FINRA member that is an investment adviser may exclude securities that are purchased as part of a fixed price offering from the calculation of annual or periodic asset-based fees that the member charges to a customer so long as the member makes the exclusion as part of its normal and
ordinary course of business with the customer and not in connection with an offering. FINRA does not provide further guidance on what “not in connection with an offering” means in this context, since the exclusion from the calculation of the asset-based fee is specifically for securities purchased in a fixed price offering. FINRA also does not address a different method sometimes used by members that charge customers an asset-based fee. In some offerings, two fixed prices are disclosed – the first to customers who pay transaction fees to their brokers, and thus purchase the fixed price securities at the full price, and the second to customers who pay asset-based fees to their brokers, and thus purchase the fixed price securities at the full price minus the portion of the underwriting discount that would otherwise be retained by their brokers. It would appear that both of these methods would continue to be permitted under the proposed Rule.

COMMENT PERIOD AND RULEMAKING PROCESS
FINRA has requested comments on proposed Rule 5141, which must be submitted in writing by September 18, 2009. If FINRA staff determine to proceed with Rule 5141 after reviewing comments, the proposed Rule must be authorized for filing with the SEC by the FINRA Board of Governors, published for further public comment in the Federal Register and approved by the SEC. Sullivan & Cromwell LLP plans to submit a letter of comments.

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