IPO Allocations Rule

FINRA Files Amended Rule Governing Allocations and Distributions in Initial Public Offerings

SUMMARY

FINRA has filed a third amendment to proposed Rule 5131 (originally proposed as NASD Rule 2712) regarding IPO allocations and distributions. The rule, first proposed in 2002 and amended in 2003 but not yet adopted, would regulate member firms involved in the distribution of initial public offerings in the following ways:

- **Quid Pro Quo Allocations:** The rule would prohibit a member and its associated persons from offering, or threatening to withhold, shares it allocates in an IPO as consideration or inducement for the receipt of compensation that is excessive in relation to the services provided by the member.

- **Spinning:** The rule would prohibit a member and its associated persons from allocating IPO shares to the account of an executive officer or director of a company (which may be public or private, U.S. or non-U.S.) (1) 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; (2) if the member intends to provide, or expects to be retained by the company for, investment banking services within the next three months or (3) on the express or implied condition that the executive officer or director, on behalf of the company, will retain the member for the performance of future investment banking services.

- **Policies Concerning Flipping:** The rule would prohibit members and their associated persons 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 in an IPO that are subsequently flipped by a customer, unless the managing underwriter has assessed a penalty bid on the entire syndicate, and would require members to maintain records regarding penalties or disincentives assessed on associated persons in connection with a penalty bid.

- **Reports of Indications of Interest and Final Allocations:** The rule would require the book-running lead manager in an equity IPO to provide to the issuer’s pricing committee a regular report of indications of interest from institutional investors by name and from retail investors in the aggregate and a report of the final allocation to institutional investors by name and aggregate sales to retail investors.

- **Lock-Up Agreement:** The rule would require that lock-up agreements restricting the transfer of the issuer’s shares by officers and directors of the issuer provide, among other things, that any waiver of the transfer restriction by the underwriters be preceded, at least two business days in advance, by notice to the issuer and announcement through a major news service of the impending waiver.
provision has an exception for a waiver 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 in place for the transferor.

- Agreement Among Underwriters: The rule would require the agreement between the book-running lead manager and other syndicate members to require that if the shares are trading at a premium to the public offering price, any shares returned by a purchaser to a syndicate member after secondary market trading commences (a) be used to offset the existing syndicate short position or (b) if no syndicate short position exists, be offered for sale at the public offering price to unfilled customer orders pursuant to a random allocation methodology.

- Market Orders: The rule would prohibit members from accepting a market order for the purchase of IPO shares prior to the commencement of trading on the secondary market. The original proposal would have prohibited the acceptance of market orders on the first day of trading as well.

Amendment No. 3 to the rule proposal was filed with the SEC on February 17, 2010 and the SEC issued the proposal for comments on March 11, 2010. The release was published in the Federal Register on March 18, 2010. Comments are due on April 8, 2010.

**CHANGES TO PROPOSED RULE**

**Investment Banking Business Following an Allocation.** The proposed rule previously provided that no member or person associated with a member would be permitted to allocate IPO shares to an executive officer or director of a company if, among other things, the member expects to receive or intends to seek investment banking business from that company within the next six months, and created a rebuttable presumption that if the member receives investment banking business from that company in that six-month period, the member made the allocation with the expectation or intent to receive that business. FINRA proposes to amend that provision by eliminating the presumption and reducing the period from six months to three.

FINRA stated that it was persuaded by commenters who said that imposing the presumption would have shifted the burden of proof to member firms to demonstrate that a past allocation was not part of a quid pro quo arrangement for investment banking business. However, it also said that where an executive officer or director receives an IPO allocation and the investment bank is then retained for investment banking services within the following three months, FINRA will investigate what the firm knew about the business relationship, including a review of the communications between the firm and the investment banking client as well as the member’s system for logging and managing prospective and current client and transaction information.

FINRA also said that it was persuaded by commenters who said that six months following the allocation is too long and that the period should be coordinated with the research disclosure requirement of NASD Rule 2711 (Research Analysts and Research Reports). The latter requires disclosure in a research report.

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1 SEC Release No. 34-61690.
2 75 FR 13176.
if the member expects to receive compensation for investment banking services from a subject company during the three-month period following publication of the report.

**Account of an Executive Officer or Director.** The spinning prohibition has been changed to prohibit the allocation of IPO shares to “the account of an executive officer or director of a company,” rather than to “an executive officer or director of a company, or to a person materially supported by such executive officer or director” (emphasis added). The category of companies covered by this provision is not limited to U.S. public companies, but also includes non-U.S. companies and private companies. The revised proposal is modeled on Rule 5130, which prohibits sales of new issue securities to the account of a restricted person. “Account of an executive officer or director” would be defined to mean:

Any account in which an executive officer or director of a company, or a person materially supported by such executive officer or director, has a financial interest or over which such executive, director or materially supported person has discretion or control, other than:

(A) an investment company registered under the Investment Company Act;

(B) any other investment fund over which neither an executive officer, director or materially supported person has discretion or control, provided that executive officers, directors and materially supported persons collectively own interests representing no more than 25% of the assets of the fund.

The term “material support” is also defined. To materially support someone means directly or indirectly providing more than 25% of a person’s income in the prior calendar year, with persons living in the same household deemed to be providing each other with material support. Commenters objected that including all persons materially supported by the executive officer or director would increase the compliance burden of tracking persons to whom allocations may not be made. FINRA pointed out that the category of persons materially supported by other persons is also found in Rule 5130, and asserted that this burden can be addressed by developing policies and procedures reasonably designed to identify the persons covered by the rule.

Experience with Rule 5130, which requires member firms selling IPO shares to an investment fund to obtain information from the fund about whether restricted persons beneficially own more than 10% of the fund interests, indicates that investment funds generally do not want to disclose the identities of their owners. As a result, it has become standard procedure, sanctioned by Rule 5130, for fund managers to obtain information, using annual questionnaires, from fund investors about whether they are restricted persons, and to provide the resulting information to the fund’s brokers on a no-names basis. This approach may not be practical with regard to the anti-spinning rule. To begin with, the rule does not permit members to rely on information from questionnaires obtained annually. More importantly, fund investors who are executive officers, directors and materially supported persons may not know whether they are restricted under the anti-spinning rule because they may not know whether a particular member firm has provided or intends to provide investment banking services to the company with which they or
their supporting persons are associated. Other approaches, such as asking investors whether they are associated with any company and confirming that those so associated do not own more than 25% of the fund, may be feasible but overly restrictive.

**Exception for Issuer Directed Programs.** In response to comments, FINRA added Supplementary Material .01, which excludes from the prohibition on spinning allocations of securities that are 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 issuer-directed securities.

Commenters requested that there be a similar exception for allocations made by a separately organized investment adviser. FINRA acknowledged that an exception of this kind was included in the so-called Voluntary Initiative entered into by certain investment banking firms in 2003 in connection with regulatory investigations relating to IPO practices. However, FINRA declined to add such an exception to Rule 5131, stating that doing so would "create a significant loophole through which the member and its affiliates may indirectly engage in the same abusive conduct the spinning rule is designed to address."

**Reallocation of Returned Shares.** Commenters were concerned about the application of the provision prescribing how returned shares must be reallocated in the case where the current market price is below the IPO price. FINRA recognized that allocating returned shares to unfilled customer orders in this case was not appropriate, and modified the provision so it applies only when the IPO shares are trading at a premium in the secondary market.

Commenters were also concerned that the reallocation of shares subsequent to the commencement of aftermarket trading may be considered to be new sales of securities that continue the distribution of the IPO shares with the result that members’ market-making purchases in the aftermarket may be deemed to violate SEC Regulation M. FINRA amended the provision relating to agreements among underwriters and returned shares to provide that it applies "to the extent not inconsistent with SEC Regulation M."

**SEC Request for Additional Comment.** In its release on the rule proposal, the SEC requested comment on an additional point: whether proposed Rule 5131(b)’s spinning provision should be modified to include a mandatory ban prohibiting members from seeking or providing investment banking services to a company for a period of 12 months following any allocation of IPO shares to an account of an executive officer or director of such company. This would presumably replace the prohibition on allocating IPO shares to the account of an executive officer or director if the member intends to provide, or expects to be retained by the company for, investment banking services within the next three months.

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CONTACTS

New York

<table>
<thead>
<tr>
<th>Name</th>
<th>Phone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>Robert E. Buckholz, Jr.</td>
<td>+1-212-558-3876</td>
<td><a href="mailto:buckholzr@sullcrom.com">buckholzr@sullcrom.com</a></td>
</tr>
<tr>
<td>David B. Harms</td>
<td>+1-212-558-3882</td>
<td><a href="mailto:harmsd@sullcrom.com">harmsd@sullcrom.com</a></td>
</tr>
<tr>
<td>Peter W. LaVigne</td>
<td>+1-212-558-7402</td>
<td><a href="mailto:lavignep@sullcrom.com">lavignep@sullcrom.com</a></td>
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