



## Proposed Amendment to FINRA Rule 5131

On April 18, 2011, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed a proposed rule change with the Securities and Exchange Commission (“SEC”) which proposes to amend paragraphs (b) and (d)(4) of FINRA Rule 5131 (the “Amendment”).<sup>1</sup> The proposed changes amend the spinning provisions (Rule 5131(b)) and the market order provisions (Rule 5131(d)(4)). In addition, the Amendment proposes delaying the effective date for the spinning provisions and the market order provisions to September 26, 2011, an additional four months. On April 26, 2011, the SEC released a notice regarding the rule change and solicited comments from the public.<sup>2</sup> Comments are due on or prior to the date that is 15 days from the publication of the notice in the Federal Register. The SEC declared that, within 45 days of the date of publication of the notice in the Federal Register or within such longer period (i) as the SEC may designate (up to 90 days of such date if the SEC finds such longer period to be appropriate and publishes its reasons for so finding) or (ii) as to which FINRA consents, the SEC will either approve or disapprove the proposed rule change or institute proceedings to determine whether the proposed rule change should be disapproved. The SEC also noted that it is considering granting accelerated approval of the proposed rule change at the end of a 15-day comment period.

Adopting Rule 5131 has been on the agenda for some time. In 2002, the National Association of Securities Dealers, Inc., the predecessor to FINRA, proposed Rule 2712 to address alleged abuses in the allocation and distribution of securities in initial public offerings (“IPOs”). On September 29, 2010, the SEC approved FINRA Rule 5131, on an accelerated basis, and solicited comments on the proposed final rule.<sup>3</sup> The approved version of Rule 5131 represented the fourth amendment of the original rule proposal. For a detailed discussion of Rule 5131 and its regulatory history, consult our recent Client Alert “Spinning: FINRA Rule 5131.” In November 2010, FINRA issued Regulatory Notice 10-60 announcing that the SEC had approved Rule 5131 and that it would go into effect on May 27, 2011.<sup>4</sup>

The first change proposed by FINRA in the Amendment relates to the prohibition on spinning. Spinning refers to the practice by certain underwriters of allocating “hot” IPO shares to directors and/or executives of potential investment banking clients in exchange for investment banking business. As approved in November 2010, Rules 5131(b)(2) and (3) prohibit the allocation of new issue shares to any account in which an executive officer or director of a public company or covered non-public company, or a person materially supported by such executive

<sup>1</sup> See <http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p123521.pdf>.

<sup>2</sup> See “Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change to Amend FINRA Rule 5131 (New Issue Allocations and Distributions),” on SEC website, <http://www.sec.gov/rules/sro/finra/2011/34-64341.pdf>.

<sup>3</sup> See “Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 4 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment Nos. 1 through 4, Relating to the Prohibition of Certain Abuses in the Allocation and Distribution of Shares in Initial Public Offerings,” on SEC website, <http://www.sec.gov/rules/sro/nasd/2010/34-63010.pdf>.

<sup>4</sup> See “Regulatory Notice 10-60: SEC Approves New FINRA Rule to Address Abuses in the Allocation and Distribution of New Issues,” on FINRA website, <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122490.pdf>.

officer or director, has a beneficial interest: (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 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 (3) 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. There are certain exceptions to the spinning prohibition.

Paragraph (b)(1) of the rule requires that member firms 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 a member.<sup>5</sup> When proposed in September 2010, FINRA noted that while establishing such policies had become customary, it wanted to ensure that such policies and procedures remain in force at member firms. However, the term investment banking personnel is not defined in the rule. According to FINRA, member firms have noted their concern that if the term is read together with the definition of investment banking services, Rule 5131(b)(1) would prohibit certain essential functions traditionally performed by syndicate personnel. As this was not the intended consequence, FINRA is proposing to delete all of clause (b)(1). FINRA noted that it believes that the benefits of the anti-spinning provisions can be obtained without clause (b)(1) since NASD Rule 3010(b)(2) requires that member firms establish written policies and procedures with respect to spinning prohibitions. No other changes to Rule 5131(b) have been proposed other than the deletion of clause (b)(1).

The Amendment also proposes that the implementation date of amended Rule 5131(b) be postponed until September 26, 2011. In the amended rule proposal, FINRA noted member firms' concerns with being able to comply with the new spinning rules in such a short time frame. Compliance measures described by FINRA include the preparation of additional forms and account documents, and other methods of collecting information from clients; building systems and surveillance infrastructure to ensure appropriate blocks of allocations; and developing proper compliance policies and procedures, and training materials on the new policies and procedures.<sup>6</sup>

The second change proposed by FINRA in the Amendment relates to market orders. Rule 5131(d)(4) as approved in November 2010 provides that no FINRA member may accept a market order for the purchase of shares of a new issue in the secondary market prior to the commencement of trading of the shares in the secondary market. According to FINRA, member firms have requested additional time prior to the effectiveness of this provision to develop processes for identifying shares of a new issue and to modify their order handling systems to prevent the acceptance of market orders in new issue shares in contravention of this new rule.<sup>7</sup> FINRA proposed that the effectiveness of Rule 5131(d)(4) be postponed until September 26, 2011.

FINRA stated in the amended rule proposal that it believes the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Securities Exchange Act of 1934 which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.<sup>8</sup> According to FINRA, it believes the proposed rule change simplifies member obligations with respect to Rule 5131, thereby aiding member compliance efforts and helping to maintain investor confidence in the capital markets.<sup>9</sup> The Amendment does not represent significant changes to the current version of the rule. Member firms and other market participants that have commenced preparing their Rule 5131 compliance efforts need not change their efforts.

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<sup>5</sup> See *id.*

<sup>6</sup> See *id.*, n. 5.

<sup>7</sup> See *id.*

<sup>8</sup> See *id.*

<sup>9</sup> See *id.*

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