



## Spinning: FINRA Rule 5131

On September 29, 2010, the Securities and Exchange Commission (“SEC”) approved FINRA Rule 5131, on an accelerated basis, and solicited comments on the proposed final rule. The approval is available at <http://www.sec.gov/rules/sro/nasd/2010/34-63010.pdf>.

### Background

In 2002, the National Association of Securities Dealers, Inc. (the “NASD”) proposed Rule 2712 to address alleged abuses in the allocation and distribution of securities in initial public offerings (“IPOs”).<sup>1</sup> In the late 1990s and 2000, an unusually large number of IPOs experienced substantial, immediate price increases upon the initiation of trading.<sup>2</sup> The ability of investors to realize immediate profits on the first day of trading of a newly public security biased the allocation process as underwriters could essentially distribute profitable trades. Some underwriters allocated IPO shares to investors that could either share the profits or promise future business to the institution. Some institutional investors entered into improper arrangements in order to participate in IPOs due to the high likelihood of profitability.<sup>3</sup>

The rule proposal was amended four times since it was first proposed. The fourth amendment (“Amendment No. 4”) was published by FINRA, the successor to the NASD, on July 30, 2010. The proposed final rule approved by the SEC incorporates the changes included in Amendment No. 4. Under FINRA’s current regulatory structure, the proposed rule is Rule 5131 (“Rule 5131”). Rule 5131 addresses potential abuses in the allocation and distribution of securities in IPOs by regulating the following activities:

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

<sup>1</sup> See SEC Release No. 34-50896, Notice of Filing of Proposed Rule Changes by the New York Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. relating to the Prohibition of Certain Abuses in the Allocation and Distribution of Shares in Initial Public Offerings (“IPOs”), December 20, 2004, available at: <http://www.sec.gov/rules/sro/nyse/34-50896.pdf>.

<sup>2</sup> See Report and Recommendations of a Committee Convened by the New York Stock Exchange, Inc. and NASD at the request of the U.S. Securities and Exchange Commission dated May 2003, available at <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p010373.pdf> (the “Report”).

<sup>3</sup> See SEC Release No. 34-50896.

## Quid Pro Quo Allocations

FINRA Rule 5131(a) prohibits any FINRA member or person associated with a member from offering or threatening 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 FINRA member. Commenters had noted their concerns regarding the uncertainty of the term “excessive.” However, Amendment No. 4 did not include any substantive changes to this provision. FINRA’s position is that determinations regarding whether compensation is excessive will be “based upon all of the 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” and that the language, as drafted, provides FINRA with the flexibility necessary to address the range of potential quid pro quo arrangements that may arise.

## 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.<sup>4</sup> Rule 5131, as proposed in Amendment No. 4, prohibits 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 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. This prohibition does not apply to allocations directed in writing by the issuer, its affiliates, or selling shareholders, provided that the member has no involvement or influence, directly or indirectly, in the allocation decisions of such persons. This exception protects directed share and similar programs.

Most commenters had sought to narrow the application of the spinning provision. Amendment No. 4 incorporates a number of changes to the rule in response to comments. The first change is the addition of Rule 5131(b)(1), 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. FINRA noted that while establishing such policies has become customary, it wants to ensure that such policies and procedures remain in force.

FINRA noted that certain commenters argued that the spinning provisions should only apply to hot IPOs. However, the spinning provisions apply to all new issues, as defined in Rule 5130(i)(9). Rule 5130(i)(9) defines the term “new issue” as “any initial public offering of any 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.” The definition excludes a number of offerings that are either exempt from registration or are offerings of securities that are not common stock. In Amendment No. 3 of the rule, the provision had applied to all IPOs. By changing the application to new issues rather than IPOs, FINRA eliminated the application of the provision to certain offerings that are not likely to trade at a premium in the aftermarket. FINRA chose not to limit Rule 5131 to hot IPOs as doing so would make the rule subject to an “unknown future event,” the opening price of the issue, and would therefore lead to compliance issues.

In Amendment No. 4, FINRA narrowed the application of the spinning provision by limiting its application to accounts 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 (each, a “restricted person”), has a beneficial

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<sup>4</sup> See the Report.

interest. 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 criteria are based on the quantitative initial listing standards of a national stock exchange, as FINRA believes that the criteria present a suitable proxy for the types of companies likely to be targeted by investment bankers.

FINRA also narrowed the applicability of Rule 5131 in Amendment No. 4 by changing the types of accounts that are subject to the rule. The spinning provisions, as set forth in Amendment No. 3, would have applied to any account in which a restricted person of any company had a financial interest, subject to certain exceptions. By limiting the application to public and covered non-public companies, the accounts of restricted persons of many private companies are not included within the scope of the provisions. Accordingly, the focus of the rule, and the compliance efforts of members, is on allocations that have the greatest potential for abuse.

In addition to changing the scope of the type of company for which restricted persons are subject to the spinning provisions, Amendment No. 4 also changed the nature of their interest in the accounts for purposes of applicability of the provision. Rule 5131 is limited to accounts in which a restricted person has a beneficial interest. The term beneficial interest has the same definition as in FINRA Rule 5130. The term “beneficial interest” is defined as any “economic interest, such as the right to share in gains or losses” and expressly states that the receipt of a management or performance based fee for operating a collective investment account, or other fees for acting in a fiduciary capacity, shall not be considered a beneficial interest. By limiting the application of the provisions to accounts in which the restricted person has an economic interest, rather than accounts over which the restricted person has discretion or control, the spinning provisions should not unduly impact allocations to certain funds. Further, the spinning prohibitions do not apply to the accounts described in Rule 5130(c)(1) through (3) and (5) through (10), or to any other account in which the beneficial interests of restricted persons in the aggregate do not exceed 25% of the account. FINRA is focusing the rule on the types of accounts that have a higher probability of abuse.

Earlier versions of the proposed rule prohibited a FINRA member or person associated with a member from allocating IPO shares to the accounts of executive officers or directors of companies if, among other things, the member intends to provide, or expects to be retained by the applicable company for, investment banking business within the three-month period following the offering. One commenter noted that it would be hard to determine when a member intends to provide investment banking services. In light of that comment and the fact that FINRA added the requirement to establish and enforce policies and procedures in Rule 5131(b)(1), FINRA qualifies the foregoing provision in Amendment No. 4 by limiting it to circumstances under which the person responsible for making the allocation decision “knows or has reason to know” of such intentions or expectations. FINRA noted in the rule proposal that if an executive officer or director receives an allocation and the investment bank is subsequently retained for investment banking services within a three-month window by such executive officer’s or director’s employing company, FINRA will investigate the business relationship and evaluate what was known (and by whom) at the time of the allocation. This 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 a review of the member’s systems for logging and managing prospective and current client and transaction information.

Last, in response to requests from commenters, Amendment No. 4 permits members to rely on written representations from the beneficial owner of an account affirmatively stating whether the holder is a restricted

person with respect to any company, and identifying such company, if applicable, as long as the representations are obtained within the preceding 12 months. Representations may be updated annually with negative consent letters. FINRA cautions, however, that a member may not rely on any representation that the member believes, or has reason to believe, is inaccurate. A member is required to maintain a copy of all records and information relating to whether an account is eligible to receive an allocation of the new issue in its files for at least three years following the member's allocation to that account. This provision, which is memorialized in the supplementary materials to the rule, facilitates compliance with the spinning provisions as it would be difficult for members to identify the universe of officers and directors subject to the rule without documentation from such persons.

## Flipping

Flipping refers to initial sale of new issue shares purchased in an offering within 30 days following the relevant offering date. Rule 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

### *Reports of Indications of Interest and Final Allocations*

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, as applicable. Such records must include the names of interested institutional investors and the numbers of shares indicated by each of them, and a report of aggregate demand from retail investors. After the settlement date, the reports must include the 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. In Amendment No. 4, FINRA clarifies that this requirement 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, FINRA clarifies that 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, to the extent not inconsistent with Regulation M, 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. Commenters claimed that the rule unnecessarily requires syndicate members to reduce the syndicate's short position regardless of market conditions, and that syndicate members should have the discretion to either use the returned shares to reduce the syndicate position or to fill unfilled customer orders. FINRA did not agree with this observation but did introduce some flexibility in Amendment No. 4 by adding the ability to sell the shares on the open market, while donating the profits to an unaffiliated charitable organization. In its comment letter, the Securities Industry and Financial Markets Association (SIFMA) asked that FINRA clarify that anonymous, ordinary course sales on a national securities exchange or ATS at market prices be considered random allocations with respect to this provision but FINRA did not incorporate this notion.

### *Market Orders*

Rule 5131 provides that no 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 such shares in the secondary market.

### **Conclusion**

Certain of the provisions set forth in Rule 5131 have been handled by market participants voluntarily or otherwise in the years since Rule 5131 was first proposed. In addition, other rules and regulations have been adopted during that time that may achieve the same goals as Rule 5131. However, as Rule 5131 will soon be effective, underwriters should review their internal policies and procedures at this time.

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