WINSTON & STRAWN LLP

Financial Services

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# Update on New FINRA Rules and Rule Proposals for Public Offerings

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The Financial Industry Regulatory Authority ("FINRA") has been active in proposing new rules and providing interpretative guidance affecting FINRA-member firms ("members") in the distribution of initial public offerings, which will impact underwriting and distribution arrangements. These developments are summarized below, along with a FINRA Concept Proposal to Require a Disclosure Statement for Retail Investors at or Before Commencing a Business Relationship.

## FINRA Rule 5131 – New Issue Allocations and Distributions

FINRA Rule 5131 is intended to specifically prohibit certain abuses in the allocation and distribution of shares in new issues, (*i.e.*, initial public offerings of equity ("IPOs")).[1] The rule covers practices known as *quid pro quo* allocations, spinning and flipping, and IPO pricing and trading practices relating to indications of interest, lock-up agreements, returned shares, and market orders. It was originally proposed in 2002 as NASD Rule 2712 to address certain abuses in the distribution and allocation of IPOs that were well-publicized at the time.[2]

*Quid Pro Quo Allocations*. FINRA Rule 5131(a) prohibits a member from offering or threatening to withhold shares it allocates in an IPO as consideration or inducement allocations for the receipt of compensation that is excessive in relation to the services provided by the member. FINRA did not define what is excessive beyond saying that whether or not compensation is excessive will be based on relevant facts and circumstances.

*Spinning.* Spinning is the practice of allocating IPO shares to the account of a person that is in a position to influence the direction of investment banking services to a member. FINRA Rule 5131(b) prohibits allocating IPO shares to a person, such as the executive officer or director of a company: (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 such executive officer or director, on behalf of the company, will retain the member for the performance of future investment banking services. FINRA members will need to establish 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 the member.

*Flipping.* Flipping is defined to mean the initial sale by a customer within 30 days, following the IPO offering date.[3] FINRA Rule 5131(c) prohibits directly or indirectly recouping, or attempting to recoup, any portion of a commission or credit paid or awarded to a member firm's associated person for selling shares of an IPO that are subsequently flipped, unless the

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[1] FINRA Rule 5131 defines a new issue to have the same meaning as in FINRA Rule 5130(i)(9), which is essentially any initial public offering of an equity security, subject to certain exclusions.

[2] See NASD Notice to Members 02-55.

[3] FINRA Rule 5131(e)(4).

managing underwriter has assessed a penalty bid on the entire syndicate. The rule also requires that members retain records regarding any penalties or disincentives assessed on its associated persons in connection with a penalty bid.

### *IPO Pricing and Trading Practices.*

1. Indications of Interest. FINRA Rule 5131(d)(1) requires that the book-running lead manager in an IPO provide to the issuer's pricing committee (or, if the issuer has no pricing committee, its board of directors): (1) a regular report of indications of interest, including the names of interested institutional investors and the number of shares indicated by each, as reflected in the book-running lead manager's book of potential institutional orders, and a report of aggregate demand from retail investors; and (2) after the settlement date of the new issue, a report of the final allocation of shares to institutional investors as reflected in the books and records of the book-running lead manager, including the names of purchasers and the number of shares purchased by each, and aggregate sales to retail investors.

2. Lock-Up Agreements. FINRA Rule 5131(d)(2) requires that any lock-up agreement or other restriction on the transfer of the issuer's shares by officers and directors of the issuer entered into in connection with an IPO must provide that such restrictions will apply to their issuer-directed shares. It also must provide that, at least two business days before the release or waiver of any lock-up or other restriction on the transfer of the issuer's shares, that the book-running lead manager will notify the issuer of the impending release or waiver and announce the impending release or waiver through a major news service. There are exceptions to this notification requirement where the release or waiver is 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 terms in place for the transferor.

3. Returned Shares. FINRA Rule 5131(d)(3) requires that the agreement between the book-running lead manager and other syndicate members must require, to the extent not inconsistent with SEC Regulation M, that any shares trading at a premium to the public offering price that are returned by a purchaser to a syndicate member after secondary market trading commences must be used to offset the existing syndicate short position or, if no short position exists, the FINRA member may either: (1) offer returned shares at the public offering price to unfilled customers' orders pursuant to a random allocation methodology, or (2) sell returned shares in the secondary market and anonymously donate the profits from the sale to an unaffiliated charitable organization.

4. Market Orders. FINRA Rule 5131(d)(4) requires 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 such shares in the secondary market.

New FINRA Rule 5131 is to be implemented by FINRA through the issuance of a Regulatory Notice, which has not yet been issued.

## FINRA Rule 5141 - Sale of Securities in a Fixed Price Offering

In October 2010, FINRA published Regulatory Notice 10-47, which makes February 8, 2011 the effective date of FINRA Rule 5141. FINRA Rule 5141 is a new, consolidated rule that replaces the "Papilsky rules" and related interpretative guidance.[4] It is intended to protect the integrity of fixed price offerings[5] by ensuring that securities in such offerings are sold to the public at the stated public offering price, or prices, thus preventing sales at a better undisclosed price. The rule prohibits the grant of certain preferences (*e.g.*, selling concessions, discounts, other allowances, or various economic equivalents) in connection with fixed price offerings of securities.

The supplementary material to FINRA Rule 5141 provides certain exclusions. One exclusion is provided for sales of securities to persons or accounts that have received research provided the soft dollar safe harbor for research provided under Section 28(e) of the Securities Exchange Act of 1934, as amended.[6] Another exclusion is provided for transactions between a member of a selling syndicate or selling group, or between a single underwriter, 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.[7] In addition, a member that is an investment adviser may exempt 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 a customer, provided the exemption is part of the member's normal and ordinary course of business with the customer and is not in connection with an offering.[8]

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[4] This reference is because of the court decision with which the rules are commonly associated. *See Papilsky v. Berndt,* Fed. Sec. L. Rep (CCH) ¶ 95,627 (S.D.N.Y. June 24, 1976).

[5] The definition of fixed price offering is substantially identical to that in NASD Rule 0120(h), and is defined to mean "the offering of securities at a stated public offering price or prices, all or part of which are publicly offered in the United States or any territory thereof, whether or not registered under the Securities Act." The definition excludes government or municipal securities or mutual funds. FINRA Rule 5141, supplementary material .04.

[6] *See* FINRA Rule 5141.02.

[7] *See* FINRA Rule 5141.03.

[8] *See* FINRA Rule 5141.05.

## FINRA Regulatory Notice 10-52 - Application of Rules on Communications With the Public and Institutional Sales Material and Correspondence to Certain Free Writing Prospectuses

In Regulatory Notice 10-52, FINRA has withdrawn in-part certain interpretative guidance that excluded free writing prospectuses from the requirements of NASD Rules 2210 and 2211. In the Notice, FINRA said that the content standards, the principal review requirement, and applicable filing requirements in NASD Rules 2210 (Communications with the Public) and 2211 (Institutional Sales Material and Correspondence) do apply to free writing prospectuses distributed by broker-dealers in a manner reasonably designed to lead to their broad unrestricted dissemination, as described in Rule 433 under the Securities Act of 1933, as amended (the "Securities Act").

A free writing prospectus is defined in the Securities Act as a written communication, including an electronic communication, that constitutes an offer to sell or a solicitation to buy securities in a registered offering by means other than the statutory prospectus. In the Notice, FINRA said that since it issued this guidance it has become apparent that a free writing prospectus that is distributed by a broker-dealer in a manner reasonably designed to lead to its broad unrestricted dissemination as described by Rule 433 under the Securities Act presents the same investor protection concerns as communications regulated by NASD Rules 2210 and 2211. FINRA states in the Notice that it is incorporating SEC guidance concerning the meaning of the term "broad unrestricted dissemination" to the effect that examples of broad unrestricted dissemination of a free writing prospectus by a broker-dealer would include posting such prospectus on an unrestricted website or releasing it to the media. Conversely, a broker-dealer does not make a broad unrestricted dissemination if a free writing prospectus is posted to a restricted website or sent directly to its customers, regardless of the number of customers. Thus, as set forth in endnote 7 to Regulatory Notice 10-52, FINRA is not withdrawing the 2006 Guidance insofar as it relates to free-writing prospectuses that are distributed by a broker-dealer in a manner that is not reasonably designed to lead to the broad unrestricted dissemination thereof. Thus, such materials would, under the 2006 Guidance, continue to be exempt from the provisions of NASD Rules 2210 and 2211, as the case may be. In addition, as also noted in endnote 7 to Regulatory Notice 10-52, FINRA is leaving unchanged, and thus is not withdrawing, the 2006 Guidance that provides that free-writing prospectuses – whether or not there is a broad unrestricted dissemination thereof - are not required to be filed under either FINRA Rule 5110 (formerly, NASD Rule 2710) or NASD Rule 2720 (soon to be renumbered as FINRA Rule 5121.

## FINRA Regulatory Notice 10-54 - FINRA Requests Comment on Concept Proposal to Require a Disclosure Statement for Retail Investors at or Before Commencing a Business Relationship

FINRA Regulatory Notice 10-54 requests comment on a "concept proposal" to require member firms to provide substantial written disclosures to retail investors at or before commencing a business/account relationship with such investors, including disclosures of "all fees associated with each brokerage account." The Notice discusses anticipated rulemaking by the SEC to establish a fiduciary duty for broker-dealers and draws upon the approach taken in Form ADV, which is required under the Investment Advisers Act of 1940, as amended, to be provided to each advisory customer. The disclosure is intended to enhance retail investors' understanding of the business, relationship and conflicts of their brokers. Firms would have to continue to provide the more particularized sales practice disclosures currently required in interactions between registered representatives, and customers. As proposed, in order for broker-dealers to meet the required disclosures, they would have to substantially increase the amount of documentation provided to customers.

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If you have any questions regarding any matters discussed in this briefing, please contact any of the Winston & Strawn attorneys listed below or your usual Winston & Strawn contact.

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