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FINRA ADOPTS NEW REGULATIONS TO ADDRESS THE ALLOCATION, PRICING AND TRADING OF NEW ISSUES

Ralph V. De Martino • 202.912.4825 • *rdemartino@cozen.com*
Eileen T. Salimbene • 215.665.4779 • *esalimbene@cozen.com*

The Securities and Exchange Commission recently approved Financial Industry Regulatory Authority (FINRA) Rule 5131, which will go into effect on May 27, 2011.[1] This rule imposes substantial new limitations on the initial public offering process in an effort to engender public confidence. The rule imposes prohibitions on broker-dealers (FINRA members) participating in the allocation, pricing, and trading of "new issues." For purposes of Rule 5131, "new issue" refers to any initial public offering of an equity security as defined in Section 3(a)(11) of the Securities Exchange Act of 1934, made pursuant to a registration statement or an offering circular.

Quid Pro Quo Allocations

FINRA designed Rule 5131(a) to deter FINRA members from using a new issue to obtain kickbacks from the recipient in the form of excessive compensation for other services. To accomplish this objective, this provision prohibits FINRA members or persons associated with FINRA members from offering or threatening to withhold shares of a new issue as an incentive for the receipt of compensation that is excessive in relation to the services provided by the member. Whether compensation is excessive for purposes of Rule 5131(a) depends on the relevant facts and circumstances, including the level of risk and effort involved in the transaction and the rates generally charged for those services.

Spinning

Rule 5131(b) requires FINRA members to establish, maintain, and enforce policies and procedures that prevent the involvement or influence of investment banking personnel in the allocation of new issue shares. This provision also prohibits FINRA members from allocating new issue shares to the account of executive officers and directors of current and certain former or prospective investment banking clients. Specifically, no FINRA member or person associated with a member can allocate shares of a new issue to any account in which an executive officer or director of a public company or a covered non-public company,[2] or a person materially supported by such officer or director, has a beneficial interest if: (i) 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; (ii) the person responsible for making the allocation decision knows or should know that the FINRA member intends to provide or expects to be retained for investment banking services within the next three months; or (iii) there is an express or implied condition that such executive officer or director will retain the member on behalf of the company for the performance of future investment banking services.

To determine whether a beneficial owner is an executive officer or director, or person materially supported by an executive officer or director, of a particular company, a FINRA member can rely on a written representation obtained within the prior 12 months from the beneficial owner of the account, or an authorized representative, as long as the member does not believe or have reason to believe that the representation is inaccurate.

1 FINRA Regulatory Notice 10-60.

2 A "covered non-public company" means any nonpublic company with: (i) 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; (ii) shareholders' equity of at least $30 million and a two-year operating history; or (iii) 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 aforementioned prohibitions do not apply to allocations of securities that are directed in writing by the issuer, its affiliates, or selling shareholders, so long as the FINRA member has no direct or indirect involvement or influence in such allocation decisions. Rule 5131(b)(3) specifically exempts allocations of new issues to any accounts in which the beneficial interests of executive officers and directors of the company and persons materially supported by such officers and directors in the aggregate do not exceed 25 percent of such account. This provision also exempts allocations of new issues to any of the following accounts, or any account in which the following have a beneficial interest: (i) an investment company registered under the Investment Company Act; (ii) a common trust fund or similar fund; (iii) an insurance company general, separate, or investment account; (iv) a publicly traded entity; (v) an investment company organized under the laws of a foreign jurisdiction; (vi) an Employee Retirement Income Security Act benefits plan; (vii) a statement or municipal government benefits plan; (viii) a tax-exempt charitable organization; or (ix) a church plan.[3]

Flipping

Rule 5131(c) prevents FINRA members from "flipping," which is defined as selling new issues into the secondary market at a profit within 30 days of the offering date. Since firms would prefer to discourage customers from flipping new issues, some firms permit a managing underwriter to impose a penalty bid on syndicate members to reclaim the selling concession for any allocations that were flipped. FINRA has determined that this type of policy can lead to disparate application because the associated persons may not be able to direct their customers' practices and links compensation to whether or not a customer holds onto a particular security. As a result, Rule 5131(c) prohibits a FINRA member or a person associated with a FINRA member from directly or indirectly recouping or attempting to recoup any portion of a commission or credit paid 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.

Pricing and Trading Practices

Indications of Interest

Rule 5131(d)(1) provides issuers and their pricing committees with more insight into the book-building process by requiring certain disclosures regarding the demand for the issuer's securities. This provision forces the book-running lead manager to provide to the issuer's pricing committee regular reports of indications of interest, including the names of interested institutional investors and the number of shares indicated by each as reflected in the book of potential institutional orders, as well as a report of aggregate demand from retail investors. After the settlement date of the new issue, the book-running lead manager must provide 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 the purchasers and the number of shares purchased by each, together with the aggregate sales to retail investors.

Lock-Up Agreements

Rule 5131(d)(2) ensures the broad and consistent application of lock-ups by requiring that any lock-up agreement or other restriction on the transfer of the issuer's shares entered into by officers and directors in connection with a new issue also applies to their issuer directed shares. In particular, this provision requires that any lock-up agreement applicable to the officers and directors of the issuer state 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, the book-running lead manager must notify the issuer of the impending release or waiver and announce the impending release or waiver through a major news source.[4] This requirement does not apply if the release or waiver is effected solely to permit a transfer of securities that is not for consideration and the transferee has agreed to be bound by the same lock-up agreement terms as the transferor.

Agreement Among Underwriters

In order to prevent a syndicate member from conferring almost instant and risk-free profits, Rule 5131(d)(3) requires that the agreement between the book-running lead manager and the other syndicate members must state that any shares

3 For a full description of the exempt accounts, see FINRA Rule 5130(c)(1)-(3) and (5)-(10).

4 The announcement may be made by the book-running lead manager, another member, or the issuer as long as it complies with requirements of the Rule.

trading at a premium to the IPO price that are returned to a syndicate member after secondary market trading commences should be used to offset the existing syndicate short position. If no syndicate short position exists, the member must either offer the returned shares at the public offering price to unfilled customers' orders using a random allocation method or sell the returned shares on the secondary market and donate the profits to an unaffiliated charity.[5]

Market Orders

To protect investors from the volatility associated with new issues, Rule 5131(d)(4) prohibits FINRA members from accepting a market order for the purchase of shares of a new issue in the secondary market prior to the commencement of trading in the secondary market. FINRA believes that this provision will protect investors and facilitate price discovery.

5 The donation must be treated as anonymous to avoid any reputational benefit to the member.

Recommendations

FINRA members should review and conform their policies and procedures to the rule prior to the allocation, pricing, and trading of any new issues. FINRA members should also obtain the additional representations required by Rule 5131 as part of the initial public offering process, and have investors complete Annual New Issue Questionnaires to obtain such additional representations going forward. Finally, FINRA members should adjust their order entry process to ensure that limit orders for new issues cannot be entered prior to the commencement of trading in the secondary market.