

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-63010; File No. SR-NASD-2003-140)

September 29, 2010

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 (“IPOs”)

I. Introduction

On September 15, 2003, the National Association of Securities Dealers, Inc. (“NASD”) (n/k/a the Financial Industry Regulatory Authority, Inc. (“FINRA”)) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to adopt new FINRA Rule 5131 (originally proposed as NASD Rule 2712) to further and more specifically prohibit certain abuses in the allocation and distribution of shares in initial public offerings (“IPOs”). NASD amended the proposed rule change on December 9, 2003 and August 4, 2004. On February 10, 2010, FINRA filed with the Commission Amendment No. 3 to SR-NASD-2003-140.<sup>3</sup> The Commission published the proposed rule change, as modified by Amendment No. 3, for comment in the Federal Register on March 18, 2010.<sup>4</sup> The Commission received three comment letters in response to the proposed rule change.<sup>5</sup> On July 30, 2010,

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 50896 (Dec. 20, 2004), 69 FR 77804 (Dec. 28, 2004).

<sup>4</sup> See Securities Exchange Act Release No. 61690 (March 11, 2010), 75 FR 13176 (March 18, 2010) (“Amendment No. 3”).

<sup>5</sup> See Letter from Jeffrey W. Rubin, Chair, Committee on Federal Regulation of Securities, Business Law Section, American Bar Association (“ABA”), to Elizabeth M. Murphy,

FINRA responded to the comment letters and filed Amendment No. 4 to the proposed rule change. The Commission is publishing this notice and order to solicit comments on Amendment No. 4, and to approve the proposed rule change, as modified by Amendment Nos. 1 through 4, on an accelerated basis.

## II. Description of Proposal

### a. Quid Pro Quo Allocations

Proposed FINRA Rule 5131(a) would prohibit any 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 member.

### b. Prohibition on Spinning

Proposed FINRA Rule 5131(b) would prohibit the allocation of new issue shares to the account of an 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 3 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.

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Secretary, SEC, dated April 6, 2010; Letter from Sean Davy, Managing Director, Corporate Credit Markets Division, Securities Industry Financial Markets Association (“SIFMA”), to Elizabeth M. Murphy, Secretary, SEC, dated April 8, 2010; and Letter from Ross M. Langill, Chairman & CEO, Regal Bay Investment Group LLC (“Regal”), to Elizabeth M. Murphy, Secretary, SEC, dated April 8, 2010.

FINRA also proposes that members establish, 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 the member. The spinning provision would apply to any account 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, has a beneficial interest. The term “covered non-public company” would mean any non-public company satisfying the following criteria: (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.<sup>6</sup> FINRA also proposes to prohibit new issue allocations only where 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 3 months.”

In addition, to facilitate compliance with the spinning provisions as requested by commenters, proposed new Supplementary Material .02 would expressly permit members to rely on written representations obtained within the prior 12 months from the beneficial owner(s) of

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<sup>6</sup> These criteria are based on quantitative initial listing standards for a national securities exchange, which FINRA believes is a suitable proxy for the types of companies that are likely to be targeted by members for investment banking services. In this case, FINRA has determined that the applicable standards should be no less than those required for initial listing on the NASDAQ Global Market. FINRA further believes that, in modifying the scope of companies covered by the spinning provisions, it is unnecessary to create a de minimis standard for investment banking services compensation as urged by ABA. Moreover, FINRA also believes that a de minimis standard would pose additional compliance burdens and would be susceptible to abuse by those seeking to avoid application of the proposed rule.

the account (or a person authorized to represent the beneficial owner(s)) as to whether such beneficial owner(s) is an executive officer or director (or person materially supported by an executive officer or director) and if so, the company(ies) on whose behalf such executive officer or director serves. FINRA requires that the initial representation be an affirmative representation, but will permit such representation to be updated annually through the use of negative consent letters. Finally, a member would be 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 for at least three years following the member's allocation to that account.

FINRA also proposes to include a limitation in the spinning rule providing that the spinning prohibitions would not apply to allocations made to any account described in FINRA Rule 5130(c)(1) through (3) and (5) through (10), or to any other account in which the beneficial interests of executive officers and directors of the company and persons materially supported by such executive officers and directors in the aggregate do not exceed 25% of such account.<sup>7</sup>

FINRA also proposes to add a new definition of "beneficial interest," which would have the same meaning as FINRA Rule 5130.<sup>8</sup>

FINRA proposes to use the term "new issue" throughout the proposed rule and to use the same definition provided in FINRA Rule 5130(i)(9). Thus, the proposed rule, as amended,

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<sup>7</sup> One commenter asked that hedge funds clearly be included in the proposal. See Regal. FINRA notes that hedge funds would be included where the beneficial interest of executive officers and directors of a particular company (and materially supported persons) in the aggregate exceed 25%. FINRA continues to believe that the 25% threshold is most appropriate and therefore will not increase the standard to 50% as requested by one commenter. See ABA.

<sup>8</sup> FINRA Rule 5130(i)(1) defines "beneficial interest" to mean any economic interest, such as the right to share in gains or losses. 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 in the account.

would apply to “new issues,” meaning “any initial public offering of an equity security as defined in Section 3(a)(11) of the Act, made pursuant to a registration statement or offering circular.” As such, the proposed definition of “new issue” would exclude:

- Offerings made pursuant to an exemption under Section 4(1), 4(2) or 4(6) of the Securities Act of 1933 (“Securities Act”), or Securities Act Rule 504 if the securities are "restricted securities" under Securities Act Rule 144(a)(3), or Rule 144A or Rule 505 or Rule 506 adopted thereunder;
- Offerings of exempted securities as defined in Section 3(a)(12) of the Act, and rules promulgated thereunder;
- Offerings of securities of a commodity pool operated by a commodity pool operator as defined under Section 1a(5) of the Commodity Exchange Act;
- Rights offerings, exchange offers, or offerings made pursuant to a merger or acquisition;
- Offerings of investment grade asset-backed securities;
- Offerings of convertible securities;
- Offerings of preferred securities;
- Offerings of an investment company registered under the Investment Company Act of 1940 (“Investment Company Act”);
- Offerings of securities (in ordinary share form or ADRs registered on Form F-6) that have a pre-existing market outside of the United States; and
- Offerings of a business development company as defined in Section 2(a)(48) of the Investment Company Act, a direct participation program as defined in Rule 2310(a)

or a real estate investment trust as defined in Section 856 of the Internal Revenue Code.

c. Policies Concerning Flipping

Proposed FINRA Rule 5131(c)(1) would prohibit members or persons associated with a member 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. Moreover, proposed FINRA Rule 5131(c)(2) would require, in addition to any obligation to maintain records relating to penalty bids under SEA Rule 17a-2(c)(1), that members promptly record and maintain information regarding any penalties or disincentives assessed on its associated persons in connection with a penalty bid.

d. IPO Pricing and Trading Practices

(1) Indications of Interest

Proposed FINRA Rule 5131(d)(1) would require, in a new issue, the book-running lead manager to 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

Proposed FINRA Rule 5131(d)(2) would require 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 a new issue 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, 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. The exceptions to this notification requirement are 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.

FINRA also is proposing new Supplementary Material .03 to provide that the required announcement also may be made by another member or the issuer (although it remains the responsibility of the book-running lead manager to ensure that the impending release or waiver is properly announced in compliance with this Rule).

### (3) Returned Shares

Proposed FINRA Rule 5131(d)(3) would require 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 be used to offset the existing syndicate short position. If no syndicate short position exists, proposed FINRA Rule 5131(d)(3)(B) would require the member to 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 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. Proposed FINRA Rule 5131 would establish a new definition of “unaffiliated charitable organization” to prevent such charitable donations from benefiting the member or executive officers and directors of the member (and persons they materially support).<sup>9</sup> The definition of “unaffiliated charitable organization” is closely tied to specific information charities are required to file with the Internal Revenue Service.

(4) Market Orders

Proposed FINRA Rule 5131(d)(4) would require 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.

e. Definitions

Proposed FINRA Rule 5131(d) would provide the following definitions. The term “public company” would mean any company that is registered under Section 12 of the Exchange Act or files periodic reports pursuant to Section 15(d) thereof. The term “beneficial interest” would have the same meaning as defined in FINRA Rule 5130(i)(1). The term “covered security” would mean any non-public company satisfying the following criteria: (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

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<sup>9</sup> Proposed FINRA Rule 5131(e)(9) defines “unaffiliated charitable organization” as a tax-exempt entity organized under Section 501(c)(3) of the Internal Revenue Code that is not affiliated with the member and for which no executive officer or director of the member, or person materially supported by such executive officer or director, is an individual listed or required to be listed on Part VII of Internal Revenue Service Form 990 (i.e., officers, directors, trustees, key employees, highest compensated employees and certain independent contractors).



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 term “flipped” would mean the initial sale of new issue shares purchased in an offering within 30 days following the offering date of such offering.

In addition, proposed FINRA Rule 5131(d) would define the term “investment banking services” to include, without limitation, acting as an underwriter, participating in a selling group in an offering for an issuer or otherwise acting in furtherance of a public offering of the issuer; acting as a financial adviser in a merger, acquisition or other corporate reorganization; providing venture capital, equity lines of credit, private investment, public equity transactions (PIPEs) or similar investments or otherwise acting in furtherance of a private offering of the issuer; or serving as placement agent for the issuer. Under the proposed rule, the term “material support” would mean directly or indirectly providing more than 25% of a person’s income in the prior calendar year. Persons living in the same household are deemed to be providing each other with material support. The term “new issue” would have the same meaning as in Rule 5130(i)(9). In addition, the term “penalty bid” would mean an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions. The term “unaffiliated charitable organization” would mean a tax-exempt entity organized under Section 501(c)(3) of the Internal Revenue Code that is not affiliated with the member and for which no executive officer or director of the member, or person materially supported by such executive officer or director, is an individual listed or required to be listed on Part VII of the Internal Revenue Service Form 990 (i.e., officers, directors, trustees, key employees, highest compensated employees and certain independent contractors).

### Supplementary Material

Proposed FINRA Rule 5131 would also include supplementary material regarding issuer directed allocations, in paragraph .01, which would provide that the prohibitions of paragraph (b) of the rule would not apply to 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 such issuer-directed shares. Proposed FINRA Rule 5131 would also provide supplementary material regarding annual representation, in paragraph .02, which would provide that for purposes of paragraph (b) of the rule, a member may rely on a written representation obtained within the prior 12 months within the parameters set forth in paragraph .02. The proposed rule would also provide supplementary material regarding lock-up announcements, in paragraph .03, stating that the requirement that the book-running lead manager announce the impending release or waiver of a lock-up or other restriction on the transfer of the issuer's shares shall be deemed satisfied where such announcement is made by the book-running manager, another member or the issuer, so long as such announcement otherwise complies with the requirements of paragraph (d)(2) of Rule 5131.

The text of the proposed rule change is available on FINRA's Web site at <http://www.finra.org>, at the principal office of FINRA, and at the Commission's Public Reference Room.

### III. Summary of Comments and Amendment No. 4

#### Prohibition on Spinning

Proposed FINRA Rule 5131(b) would prohibit the allocation of IPO shares to the account of an 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 3 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.

Commenters generally supported the proposed changes to the spinning rule but requested additional modifications.<sup>10</sup> Commenters' concerns included that it would be difficult to identify the universe of officers and directors subject to the rule and asked that members be permitted to rely on annual negative consent letters.<sup>11</sup> One commenter expressed particular concern regarding the applicability of the rule to officers and directors of non-public companies.<sup>12</sup>

In response to commenters' concerns, FINRA is proposing several changes to the spinning provisions. First, FINRA proposes that members establish, 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 the member. FINRA believes that such procedures are essential to managing conflicts of interest between investment banking and syndicate activities. FINRA understands that these procedures

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<sup>10</sup> See SIFMA.

<sup>11</sup> See ABA and SIFMA.

<sup>12</sup> See SIFMA.

are customary at members today, and wants to ensure that such policies and procedures remain in force.

In addition, in response to comments, FINRA proposes to narrow the scope of the non-public companies covered by the spinning provision to focus the rule and firms' compliance efforts on those allocations that have the greatest potential for abuse. Specifically, the spinning provision would apply to any account 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, has a beneficial interest. The term "covered non-public company" means any non-public company satisfying the following criteria: (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.<sup>13</sup>

One commenter stated that it may be difficult to determine when the member "intends to provide" investment banking services and asked that the member be permitted to rely on policies and procedures reasonably designed to determine whether an entity is a current or prospective investment banking client, or whether the member intends to provide investment banking

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<sup>13</sup> These criteria are based on quantitative initial listing standards for a national securities exchange, which FINRA believes is a suitable proxy for the types of companies that are likely to be targeted by members for investment banking services. In this case, FINRA has determined that the applicable standards should be no less than those required for initial listing on the NASDAQ Global Market. FINRA further believes that, in modifying the scope of companies covered by the spinning provisions, it is unnecessary to create a de minimis standard for investment banking services compensation as urged by ABA. Moreover, FINRA believe that a de minimis standard would pose additional compliance burdens and would be susceptible to abuse by those seeking to avoid application of the proposed rule.

services to a prospective client, on the basis of reasonable criteria (which criteria may limit the identification of current clients to those relationships that are more than aspirational or passing, or for which the firm has a reasonable expectation of an active near-term relationship).<sup>14</sup> FINRA does not believe that the spinning provision should be recast solely as a “policies and procedures” rule. However, in response to commenters’ concerns and in light of the provision explicitly requiring policies and procedures excluding investment banking personnel input into new issue allocation decisions, FINRA proposes to modify the three month forward looking provision to prohibit new issue allocations only where 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 3 months.” FINRA believes that this change strikes an appropriate balance in addressing the potential that new issue allocations will influence future business with the member while not unnecessarily impacting the capital formation process.<sup>15</sup> However, according to FINRA, if a member maintains effective information barriers between the investment banking and syndicate departments and the persons responsible for making new issue allocation decisions neither know nor have reason to know of the prospective business relationship, the forward-looking provision will not be violated.

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<sup>14</sup> See SIFMA.

<sup>15</sup> If an executive officer or director receives an allocation and the investment bank subsequently is retained for the performance of investment banking services within the three month window by such executive officer or director’s employing firm, FINRA will investigate the particular information about the business relationship that was known (and by whom) at the time of the allocation, including 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 the member’s systems for logging and managing prospective and current client and transaction information.

To facilitate compliance with the spinning provisions as requested by commenters, proposed new Supplementary Material .02 expressly permits members to rely on written representations obtained within the prior 12 months from the beneficial owner(s) of the account (or a person authorized to represent the beneficial owner(s)) as to whether such beneficial owner(s) is an executive officer or director (or person materially supported by an executive officer or director) and if so, the company(ies) on whose behalf such executive officer or director serves. Consistent with current practice under FINRA Rule 5130, FINRA requires that the initial representation be an affirmative representation, but will permit such representation to be updated annually through the use of negative consent letters. Members are reminded that a member may not rely upon any representation it believes, or has reason to believe, is inaccurate. Finally, a member would be 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 for at least three years following the member's allocation to that account.

FINRA notes that members should understand that the representation in the spinning context differs from that in FINRA Rule 5130 because, in the spinning case, the information obtained from the customer is not, by itself, sufficient to make a determination of whether a customer is eligible to purchase a new issue. Members also must determine whether each account considered for a new issue allocation involves an executive officer or director (or materially supported person) of a current or prospective client that falls within the scope of paragraph (b). Members may choose to adopt a more restrictive internal policy prohibiting

allocations to all executive officers, directors and materially supported persons; however, FINRA notes that this is not required under the proposed rule change.<sup>16</sup>

Commenters also asked that the definition of “account of an executive officer or director” be amended to apply to accounts in which an executive officer, director or materially supported person has a “beneficial interest” rather than a “financial interest.”<sup>17</sup> Commenters asked that the rule exclude accounts over which executive officers, directors or materially supported persons have “discretion or control” as this may unduly impact allocations to certain funds.<sup>18</sup> Commenters further argued that the definition of “account of an executive officer or director” should be modified to exclude certain other entities (such as foreign investment companies) consistent with FINRA Rule 5130(c).<sup>19</sup>

In response to comments, FINRA proposes to delete the definition of “account of an executive officer or director” and to instead include a new limitation in the spinning rule providing that the spinning prohibitions would not apply to allocations made to any account described in FINRA Rule 5130(c)(1) through (3) and (5) through (10), or to any other account in which the beneficial interests of executive officers and directors of the company and persons materially supported by such executive officers and directors in the aggregate do not exceed 25%

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<sup>16</sup> FINRA notes that the Voluntary Initiative more broadly prohibited allocations to the account of any executive officer or director of a U.S. public company or a public company for which a U.S. market is the principal equity trading market with respect to all hot IPOs. Voluntary Initiative Regarding Allocations of Securities in “Hot” Initial Public Offerings to Corporate Executives and Directors, <http://www.sec.gov/news/press/globalvolinit.htm> (Apr. 28, 2003).

<sup>17</sup> See ABA. Commenters generally favored the use of defined terms in proposed FINRA Rule 5131 that are consistent with the terms used in Rule 5130. See ABA and Regal.

<sup>18</sup> See ABA.

<sup>19</sup> See ABA.

of such account.<sup>20</sup> As requested by commenters, FINRA also proposes to add a new definition of “beneficial interest,” which will have the same meaning as FINRA Rule 5130.<sup>21</sup> FINRA believes deleting the term “account of an executive officer or director” and modifying the scope of the rule to generally exclude those accounts excepted from FINRA Rule 5130(c) is appropriate in that allocations to such accounts are not likely to result in the type of abuse the spinning prohibition is geared toward. FINRA believes that the proposal, as amended, continues to meet the goals of the rule while avoiding an unnecessary impact on capital formation. In addition, by replacing references to “financial interest” with “beneficial interest” and deleting the reference to accounts in which officers and directors exercise “discretion or control,” FINRA believes that the rule more properly focuses on accounts in which relevant parties have an economic interest.

Commenters argued that the spinning rule should apply only to “hot IPOs” and should exclude the types of offerings excepted under FINRA Rule 5130(i)(9).<sup>22</sup> FINRA does not agree that the rule should apply only to “hot IPOs.” FINRA believes that the proposed rule change should not be limited to hot IPOs for the same reasons that FINRA Rule 5130 is not limited to

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<sup>20</sup> One commenter asked that hedge funds clearly be included in the proposal. See Regal. FINRA notes that hedge funds would be included where the beneficial interest of executive officers and directors of a particular company (and materially supported persons) in the aggregate exceed 25%. FINRA continues to believe that the 25% threshold is most appropriate and therefore will not increase the standard to 50% as requested by one commenter. See ABA.

<sup>21</sup> FINRA Rule 5130(i)(1) defines “beneficial interest” to mean any economic interest, such as the right to share in gains or losses. FINRA notes 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 in the account.

<sup>22</sup> See ABA.



hot IPOs.<sup>23</sup> Specifically, the operation of a rule based on an unknown future event – the opening price – creates compliance difficulties and potentially may exacerbate spinning problems and may harm capital formation by necessitating members to cancel allocations and reallocate shares to another customer. FINRA does, however, agree that certain types of offerings that are not likely to trade at a premium in the aftermarket should be excluded from the rule. Therefore, FINRA proposes to replace the defined term “initial public offering” or “IPO” with the term “new issue” throughout the proposed rule and to use the same definition provided in FINRA Rule 5130(i)(9). In developing the definition of “new issue” in FINRA Rule 5130, FINRA carefully considered the extent to which such offerings may be hot issues. Thus, the proposed rule, as amended, applies to “new issues,” meaning “any initial public offering of an equity security as defined in Section 3(a)(11) of the Act, made pursuant to a registration statement or offering circular.”

#### IPO Pricing and Trading Practices

Commenters generally supported the amended proposal related to IPO Pricing and Trading Practices.<sup>24</sup> However, one commenter asked that FINRA include clarifying language that the lock-up provision would only apply to lock-ups entered into in connection with the IPO,

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<sup>23</sup> While earlier proposed versions of the IPO Rule would have applied only to “hot issues,” FINRA, then NASD, revised the proposal to cover the purchase and sale of all initial equity public offerings, not just those that open above a designated premium, because FINRA believed the revised approach would be easier to understand and would avoid many of the complexities associated with the cancellation provision. See Securities Exchange Act Release No. 48701 (October 24, 2003), 68 FR 62126 (October 31, 2003) (Order Approving File No. SR-NASD-99-60). (Proposed rule change relating to restrictions on the purchases and sales of initial public offerings of equity securities).

<sup>24</sup> See SIFMA.

and not with respect to other lock-up agreements.<sup>25</sup> FINRA confirms that this provision applies only to lock-up agreements entered into in connection with a new issue and has modified the rule text to reflect this.<sup>26</sup> This commenter also asked that FINRA clarify that the required notice of an impending release or waiver of a lock-up may be announced either by the issuer or the applicable member(s).<sup>27</sup> FINRA agrees that, so long as the announcement is made through a major news service at least two days before the release or waiver of any lock-up or other restriction on the transfer of the issuer's shares, the requirement is satisfied irrespective of whether such announcement is made by the book-running lead manager, another member or by the issuer. Thus, FINRA is proposing new Supplementary Material .03 in response to comments to provide that the required announcement also may be made by another member or the issuer. However, FINRA notes that it remains the responsibility of the book-running lead manager to ensure that the impending release or waiver is properly announced in compliance with this Rule.

One commenter argued that the rule should be changed to permit the syndicate to retain discretion to either use returned shares to reduce the syndicate position or toward unfilled customer orders.<sup>28</sup> FINRA does not agree that this change is appropriate. FINRA expects that when shares trade at a premium to the public offering price, the incidence of returned shares should be minimal so as not to affect the ability of syndicate members to stabilize the market for

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<sup>25</sup> See SIFMA.

<sup>26</sup> Proposed Rule 5131(d)(2), as amended, provides that “[a]ny 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 a new issue shall provide that . . .” (new language emphasized).

<sup>27</sup> See SIFMA.

<sup>28</sup> See SIFMA.

such shares to the extent stabilization activities are even necessary. Further, FINRA believes that the complexity of addressing this alternative would unnecessarily complicate the proposed rule change.<sup>29</sup> However, in response to comments, FINRA is amending the rule to provide members with additional flexibility in the handling of returned shares. The amended proposal continues to require that, to the extent not inconsistent with SEC Regulation M, the agreement between the book-running lead manager and other syndicate members must require that any shares trading at a premium to the public offering price returned by a purchaser to a syndicate member after secondary market trading commences be used to offset the existing syndicate short position.<sup>30</sup> However, where no syndicate short position exists, the proposed rule change would provide the member with the option, provided that it is in accordance with SEC Regulation M, to 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 on the secondary market and donate profits from the sale to an "unaffiliated charitable organization" with the condition that the

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<sup>29</sup> SIFMA also asked FINRA to clarify that anonymous, ordinary course sales on a national securities exchange or ATS at market prices will be considered a "random allocation" for the purposes of the rule. FINRA disagrees. The provision, as previously proposed would have required that, where no syndicate short position exists, the member must offer the returned shares to unfilled customer orders at the public offering price, not the market price. Moreover, FINRA notes that, if the shares are trading at a premium to the public offering price, then sales by the member at market prices would result in the premium inuring to the benefit of the member, which is inconsistent with the purpose of the provision and a member's obligations under FINRA Rule 5130.

<sup>30</sup> One commenter asked for confirmation that the appropriate time for determining whether returned shares are trading at a premium to their IPO price is at the time such securities are returned. FINRA agrees. See SIFMA. Another commenter argued that the requirement that members use a random allocation methodology to reallocate returned shares was inadequate. See Regal. FINRA disagrees and notes that this standard is already used successfully in other FINRA rules. See FINRA Rule 2360 (Allocation of Exercise Assignment Notices).

donation be treated as an anonymous donation to avoid any reputational benefit to the member.<sup>31</sup> Proposed FINRA Rule 5131 establishes a new definition of “unaffiliated charitable organization” to prevent such charitable donations from benefiting the member or executive officers and directors of the member (and persons they materially support). FINRA believes that charitable donations funded by returned shares should not provide any reputational benefit to the member. The definition of “unaffiliated charitable organization” is closely tied to specific information charities are required to file with the Internal Revenue Service.

The proposed rule change, as amended, prohibits the acceptance of market orders for the purchase of IPO shares prior to the commencement of trading on the secondary market. A commenter supported the proposed amendment but offered alternative rule text.<sup>32</sup> FINRA favors its existing rule text but proposes a slight modification in response to comments to further clarify the provision such that the relevant text will now state 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.”

#### Other Issues

Commenters reiterated certain concerns regarding FINRA’s proposed provision relating to abusive allocation arrangements. Proposed FINRA Rule 5131(a) prohibits a member from offering or threatening to withhold shares it allocates in an IPO as consideration or inducement

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<sup>31</sup> Proposed FINRA Rule 5131(e)(9) defines “unaffiliated charitable organization” as a tax-exempt entity organized under Section 501(c)(3) of the Internal Revenue Code that is not affiliated with the member and for which no executive officer or director of the member, or person materially supported by such executive officer or director, is an individual listed or required to be listed on Part VII of Internal Revenue Service Form 990 (*i.e.*, officers, directors, trustees, key employees, highest compensated employees and certain independent contractors).

<sup>32</sup> See SIFMA.

for the receipt of compensation that is excessive in relation to the services provided by the member (i.e., quid pro quo allocations). Commenters generally supported this proposed provision but reiterated earlier concerns that the term “excessive” is subject to uncertainty.<sup>33</sup> One commenter requested that FINRA clarify that any services provided for a “fair price” as provided by FINRA’s Corporate Financing Rule (Rule 5110(a)(9)) would not be deemed excessive.<sup>34</sup> This commenter also requested guidance that any services provided by a member paid for using “soft dollars” in conformity with Section 28(e) of the Act also would not be deemed excessive.<sup>35</sup> Another commenter asked that clarifying language be added to the rule to provide that an assessment of whether compensation is excessive would be based on 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.<sup>36</sup>

As stated in Amendment No. 3, FINRA agrees that an assessment of whether or not compensation is excessive would 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.<sup>37</sup> However, FINRA continues to believe that the proposed language, which refers to “compensation that is excessive in relation to the services provided,” is most appropriate in that it affords FINRA the necessary flexibility in addressing the range of potential quid pro quo arrangements that may arise. As stated in Amendment No. 3, FINRA

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<sup>33</sup> See ABA and SIFMA.

<sup>34</sup> See ABA.

<sup>35</sup> See ABA.

<sup>36</sup> See SIFMA.

<sup>37</sup> See Amendment No. 3.

does not believe it is necessary to include rule text stating that an assessment of whether compensation is “excessive” will be based upon all of the relevant facts and circumstances.<sup>38</sup>

Likewise, FINRA does not believe it is appropriate to provide blanket guidance regarding payments made in conformity with Section 28(e) of the Act or FINRA Rule 5110(a)(9).

Finally, one commenter raised concerns regarding FINRA’s proposed flipping provision.<sup>39</sup> This commenter argued that, instead of defining the flipping period to mean the initial sale of new issue shares within 30 days following the offering date, the flipping provision should be based on the sale of shares prior to the book manager lifting the penalty bid, making the time period under the rule subject to the discretion of the managing underwriter.<sup>40</sup> FINRA does not agree that the suggested alternative represents an improvement to the proposed provision. FINRA believes that the certainty and finality of the proposed approach, including the 30-day window, is the appropriate duration for prohibiting members from recouping commissions from associated persons whose customers sell in cases where a penalty bid has not been assessed on the entire syndicate.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no less than 90 and no more than 180 days following publication of the Regulatory Notice announcing Commission approval.

#### IV. Discussion and Commission Findings

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<sup>38</sup> See Amendment No. 3.

<sup>39</sup> See Regal.

<sup>40</sup> See Regal.

After carefully considering the proposal, the comments submitted, and FINRA’s response to the comments, the Commission finds that the proposed rule change, as modified by Amendment Nos. 1 through 4, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.<sup>41</sup> In particular, the Commission finds that the proposed rule change, as amended, is consistent with Section 15A(b)(6) of the Act,<sup>42</sup> which requires, among other things, that FINRA rules 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. In particular, the Commission believes that the proposed rule change is a reasonable step to enhance members’ avoidance of unacceptable conduct when they engage in the allocation and distribution of new issue shares. The Commission also believes that the proposed rule change is a reasonable step to enhance public confidence in the distribution of new issues.

In addition, the Commission sought specific comment in Amendment No. 3 on whether there are any alternatives to the proposed rule change that FINRA should consider, such as whether proposed Rule 5131(b)’s spinning provisions 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 and whether such a ban would facilitate compliance. One commenter strongly supported a 12-month prohibition.<sup>43</sup> However, another commenter opposed such a prohibition, saying that it “would – by rule – impose an automatic sanction for even

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<sup>41</sup> In approving this proposed rule change, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>42</sup> 15 U.S.C. 78o-3(b)(6).

<sup>43</sup> See Regal.

inadvertent allocations of IPO securities” and “would, in all cases, be financially disproportionate to the value of the securities involved in any violation, would not take into account the specific facts of each situation, deprive the FINRA member of its statutory right to a fair hearing before the imposition of any disciplinary sanction, and would unfairly deprive the company of the right to select the services of the FINRA member.”<sup>44</sup> According to this commenter, in each case, the imposition of a mandatory ban, as suggested by the Commission, would be an excessive penalty in light of the facts and circumstances underlying the potential violation of the proposed rule.<sup>45</sup> Nevertheless, this commenter noted that the 12-month prohibition “should not in any event be approved without an opportunity for review of and comment on the text of the proposed rule,” with commenter requesting that the Commission republish for comment any proposal to adopt such a mandatory ban on investment banking services with a sixty-day comment period. In light of these comments, the Commission will continue to consider the commenters’ recommendations and concerns in considering whether any future action is warranted. However, the Commission does not believe this issue should preclude approval of the proposal.

#### V. Accelerated Approval

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,<sup>46</sup> for approving the proposed rule change, as modified by Amendment Nos. 1 through 4 thereto, prior to the 30<sup>th</sup> day after the date of publication of Amendment No. 4 in the Federal Register. The changes proposed in Amendment No. 4 respond to specific concerns raised. Moreover, accelerating approval of this proposal should benefit FINRA members by aiding them in

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<sup>44</sup> See ABA.

<sup>45</sup> See id.

<sup>46</sup> 15 U.S.C.78s(b)(2).



avoiding misconduct in new issue distributions and should benefit investors by taking a step to enhance investor protection in the capital raising process.

#### VI. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as modified by Amendment No. 4, is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2003-140 on the subject line.

##### Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2003-140. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F

Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASD-2003-140 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VII. Conclusion

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR-NASD-2003-140), as modified by Amendment Nos. 1 through 4, be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>47</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>47</sup> 17 CFR 200.30-3(a)(12).