

SEC Approves Delay in Effectiveness of and Amendments to Certain Provisions of FINRA Rule 5131

On May 18, 2011, the Securities and Exchange Commission (the “SEC”) approved certain amendments to the originally adopted version of FINRA Rule 5131 “New Issue Allocations and Distributions” (“Rule 5131”) proposed by the Financial Industry Regulatory Authority, Inc. (“FINRA”) in response to timing and implementation concerns raised by various interested parties, including the Securities Industry and Financial Markets Association.¹

These amendments

- delete Rule 5131(b)(1), requiring FINRA members to ensure “investment banking personnel” are not involved in new issue allocations, and
- delay until September 26, 2011 the effectiveness of Rule 5131(b),² relating to “spinning” practices in new issue allocations, and Rule 5131(d)(4), regulating when market orders for shares of a new issue may be accepted.

According to FINRA’s rule change proposal, Rule 5131(b)(1) was removed in order to avoid the unintended consequence of preventing syndicate personnel from allocating shares of a new issue. The rule would have required FINRA members to establish policies and procedures to ensure that “investment banking personnel” were not involved in, and could not influence, new issue allocation. However, the term “investment banking personnel” was not defined and if interpreted in accordance with Rule 5131’s definition of “investment banking services” could have barred syndicate personnel from performing their usual allocation functions. In its approval order, the SEC noted that the removal of paragraph (b)(1) from Rule 5131 should aid the compliance efforts of FINRA members by simplifying their obligations under the rule.

¹ FINRA’s rule change proposal can be found at SEC Rel. No. 34-64341 (Apr. 26, 2011), 76 Fed. Reg. 24076 (Apr. 29, 2011) (File No. SR-FINRA-2011-017), and the SEC’s approval order at SEC Rel. No. 34-64512 (May 18, 2011) (File No. SR-FINRA-2011-017).

² With the deletion of Rule 5131(b)(1), paragraphs (b)(2) and (3) were redesignated as (b)(1) and (2).

The delay in the effectiveness of Rule 5131(b) until September 26, 2011 allows FINRA members the additional time they requested to create additional client account documentation that includes the information necessary to determine eligibility for new issue allocation under Rule 5131(b); build the infrastructure required to block impermissible new issue allocations; and develop related compliance and training materials. Similarly, the postponement of the effectiveness of Rule 5131(d)(4) was granted to provide time for FINRA members to modify their computerized order handling systems to prevent the acceptance of market orders for the purchase of shares of a new issue in the secondary market prior to the commencement of trading in such market.

All other provisions of Rule 5131 will enter into effect on May 27, 2011. These provisions include:

- requirements that any officer or director lock-up agreement specifically include issuer-directed shares and that such lock-up agreement not be released or waived without public announcement of such release or waiver at least two business days prior to its effectiveness (paragraph (d)(2));
- a requirement that the applicable agreement among underwriters include specific restrictions on how new issue shares returned to the syndicate and trading up in the secondary market are allocated or sold (paragraph (d)(3));
- a prohibition on *quid pro quo* allocations - allocating or withholding allocation of new issue shares in exchange for excessive compensation (paragraph (a));
- a prohibition on recoupment of sales commissions paid to a broker whose client has “flipped” shares of a new issue for a profit within 30 days of the offering date, unless the managing underwriter has assessed a penalty bid on the entire syndicate (paragraph (c)); and
- a requirement that the lead manager provide the issuer with regular reports on indications of interest in, and final allocations to, investors in a new issue (paragraph (d)(1)).

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If you have any questions about the impact of Rule 5131 on standard underwriting documentation or any other related topic of concern, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under “Capital Markets” under the “Practices” section of our website at <http://www.clearygottlieb.com>.

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