FINRA Rule 5131 – Restrictions on Allocation of IPO Shares to Executive Officers and Directors of Non-U.S. Companies

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The following discusses the application of the restrictions under FINRA Rule 5131 on the allocation of new issue equity securities ("IPO shares") to an account for the benefit of an executive officer or director (a "Covered Person")[1] of a public company or a covered non-public company, as such terms are defined by Rule 5131,[2] to an individual who is a Covered Person of a company that is not a U.S. reporting company and is not organized or located in the United States but otherwise meets the definition of a covered non-public company under Rule 5131 (a "Non-U.S. Company").

FINRA Rule 5131, which was approved by the SEC on September 29, 2010, is intended to prevent "quid pro quo" and other specified arrangements in connection with the distribution of IPO shares by FINRA member firms. Among other things, the rule prohibits a member from allocating IPO shares to executive officers or directors of companies who may be in a position to direct investment banking business to the member – known as "spinning." Specifically, Rule 5131(b)(1) provides that:

No member or person associated with a member may allocate [IPO shares] 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:

A. 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;

B. 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 3 months; or

C. 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.[3]

A "covered non-public company," by its terms, is not limited to a company that is organized or located in the United States.[4] In the release proposing Rule 5131, FINRA noted that the term applies to a company

[1] The term also includes persons materially supported by such officer or director.

[2] FINRA Rule 5131(e)(1) defines the term "public company" as "any company that is registered under Section 12 of the [Securities Exchange Act of 1934] or files periodic reports [with the U.S. Securities and Exchange Commission ("SEC" or the "Commission")] pursuant to Section 15(d) thereof." Rule 5131(e)(3) defines the term "covered non-public company" as "any non-public company satisfying the following criteria: (i) income of at least [US]$1 million in the last fiscal year or in two of the last three fiscal years and shareholders' equity of at least [US]$15 million; (ii) shareholders' equity of at least US$30 million and a two-year operating history; or (iii) total assets and total revenue of at least [US]$75 million in the latest fiscal year or in two of the last three fiscal years." These criteria are based on quantitative initial listing standards for a U.S. national securities exchange, such as NASDAQ, which FINRA considers a suitable proxy for the types of customers that are likely to be targeted by member firms for investment banking services.

[3] The spinning prohibition and its exceptions take effect on September 26, 2011. The original implementation date for the spinning prohibition was May 27, 2011. On May 23, 2011, the SEC approved a request by FINRA to delay implementation until September 26, 2011, primarily to afford member firms time to effect compliance policies and procedures to implement the prohibition.

[4] *See supra* n.1.

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"irrespective of where [it] is domiciled."[5] We requested clarification from FINRA's Office of General Counsel ("OGC") on the application of the term "covered non-public company" to a Non-U.S. Company.[6] We were advised orally by the OGC that, in their view, the term is intended to cover *all* companies, whether or not they are organized or located in the U.S., and regardless of any other factors related to the company's presence in the United States. In this regard, the OGC staff noted that a Non-U.S. Company that meets the criteria set forth in the definition is just as capable as a similarly qualified U.S. company of raising capital or performing other banking transactions in the United States; therefore, Rule 5131's prohibitions on the allocation of IPO shares to garner investment banking business should apply equally to Covered Persons of Non-U.S. Companies.[7]

Accordingly, the restrictions under FINRA Rule 5131 apply as well to the allocation of IPO shares to the account of a Covered Person of a Non-U.S. Company.

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Please contact us if you would like to discuss this issue in more detail.

[5] File No. SR-NASD-2003-140, Amendment No.3 (Feb. 17, 2010).

[6] In particular, we asked whether the term excludes a Non-U.S. Company that has no significant market for its securities in the United States.

[7] Tel. call with FINRA staff, Office of General Counsel, FINRA, on June 3, 2011.