

CORPORATE AND SECURITIES LAW

ALERT

NEWS FOR THE CLIENTS AND FRIENDS OF BASS, BERRY & SIMS PLC

FINRA Consolidates and Simplifies the “Papilsky Rules” by Promulgating Rule 5141

August 19, 2010

The Securities and Exchange Commission (“SEC”) recently approved a proposal filed by the Financial Industry Regulatory Authority, Inc. (“FINRA”) to consolidate and simplify the “Papilsky Rules”¹ and their associated interpretative materials which address sales of securities in fixed price offerings by promulgating FINRA Rule 5141 and related supplementary material (“Rule 5141”). Similar to the Papilsky Rules, the primary purpose of Rule 5141 is to protect the integrity of fixed price offerings by ensuring that securities sold in these offerings are sold to the public at the stated public offering price or prices, thereby preventing the sale of securities at an undisclosed, better price.²

The full text of Rule 5141 is [available here](#). FINRA will issue a Regulatory Notice by October 19, 2010 that will establish the effective date upon which Rule 5141 will be implemented and the Papilsky Rules will be deleted. The effective date will be no later than 180 days following the date of publication of the Regulatory Notice.

Rule 5141 Fundamentals

A significant portion of the existing regulatory scheme which governs fixed price offerings will remain after the implementation of Rule 5141; however, Rule 5141 contemplates the following modifications and clarifications to the Papilsky Rules:

Reduced Price. The purpose which underlies Rule 5141 is to preserve the integrity of the fixed price offering process. Rule 5141 addresses this core objective by providing that “[n]o member or person associated with a member that participates in a selling syndicate or selling group or that acts as the single underwriter in connection with a fixed price offering shall offer or grant, directly or indirectly, to any person or account that is not a member of the selling syndicate or selling group or that is a person or account other than the single underwriter any securities in the offering at a price

¹ The current fixed price offering rules, NASD Rules 2730, 2740 and 2750 and their associated interpretive materials, are generally known as the “Papilsky Rules” because of the court decision with which they are commonly associated, *Papilsky v. Berndt*, Fed. Sec. L. Rep (CCH) ¶ 95,627 (S.D.N.Y. June 24, 1976).

² Rule 5141 defines the term “fixed price offering” to mean “the offering of securities at a stated public offering price or prices, all or part of which securities are publicly offered in the United States or any territory thereof, whether or not registered under the Securities Act, except that the term does not include offerings of ‘exempted securities’ or ‘municipal securities’ as those terms are defined in Sections 3(a)(12) and 3(a)(29), respectively, of the Exchange Act or offerings of redeemable securities of investment companies registered pursuant to the Investment Company Act which are offered at prices determined by the net asset value of the securities.” Notably, by its very definition, the term “fixed price offering” does not include offerings of securities that are privately placed or offered and sold pursuant to Rule 144A under the Securities Act of 1933.

below the stated public offering price (a “reduced price”).³ Rule 5141 does, however, clarify that the general prohibition upon the use of reduced prices will not impact the ability of members of a selling syndicate or selling group to purchase and sell securities in the fixed price offering among themselves at a reduced price. Additionally, Rule 5141 also provides that a member that participates in a selling syndicate or selling group or that acts as the single underwriter may, subject to certain restrictions applicable to initial equity public offerings, sell securities in a fixed price offering to an affiliated person provided that the sale is not consummated at a reduced price.

Research. Rule 5141 generally preserves the allowance afforded to research services by clarifying that Rule 5141 does not prohibit a member or person associated with a member that participates in a selling syndicate or selling group or that is a single underwriter from selling securities in the offering to a person or account to which it has provided or will provide research, provided that the person or account pays the stated public offering price for the securities and the research satisfies the requirements of Sections 28(e)(3)(A) and (B) of the Securities Exchange Act of 1934 and related SEC guidance. Further, Rule 5141 provides that investment management or investment discretionary services are not considered to be research and requires that any product or service provided by a member or person associated with a member that does not qualify as research must not confer a reduced price.

Ordinary Course Transactions. Rule 5141 provides that transactions between a member of the selling syndicate or selling group or 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 will not be deemed to confer a reduced price under Rule 5141.

Asset-Based Fees. Rule 5141 provides that members that are investment advisers may exempt securities that are purchased as part of a fixed price offering from the calculation of annual or periodic asset-based fees that such member charges to a customer, provided such exemption is part of the member’s normal and ordinary course of business with the customer and is not in connection with an offering. Although Rule 5141 does not specifically address the alternative practice of disclosing two fixed public offering prices, whereby one price includes the full underwriting discount and a second price excludes all or a portion of the underwriting discount and is applicable to those purchasers who already pay asset-based fees to the participating member, in the prospectus or similar offering document, such practice should continue to be permitted under Rule 5141 provided that the multiple fixed prices are adequately disclosed.⁴

Rule 5141 Implications

As set forth below, in addition to modifying and clarifying technical provisions of the Papilsky Rules, Rule 5141 will relieve members of certain administrative duties and will likely preserve and facilitate members’ ability to engage in certain transactions.

Filings and Records. Unlike the Papilsky Rules, Rule 5141 does not require members to make quarterly filings with FINRA in respect of designated sales and to keep and maintain specific records that evidence the receipt of selling credit as designated by their customers. Members will, however,

³ Rule 5141 defines the term “reduced price” to include, without limitation, “any offer or grant of any selling concession, discount or other allowance, credit, rebate, reduction of any fee (including any advisory or service fee), any sale of products or services at prices below reasonable commercially available rates for similar products and services . . . or any purchase of or arrangement to purchase securities from the person or account at more than their fair market price in exchange for securities in the offering.”

⁴ The term “fixed price offering” does not prohibit “multiple price” offerings provided that the different fixed prices are adequately disclosed. See [Notice to Members](#) 81-3.

remain subject to other applicable FINRA and SEC recordkeeping requirements.

Duration of Reduced Price Prohibition. Rule 5141 provides that the prohibition upon the use of reduced prices applies only until the termination of the fixed price offering or until a member, having made a bona fide public offering of the securities, is unable to sell or to continue selling such securities at the stated public offering price.⁵ Accordingly, if a fixed price offering is undersubscribed, Rule 5141 appears to preserve certain remedial practices such that underwriters may (i) alter the initial fixed offering price if they are unable to sell all or a portion of the offered securities at such price or (ii) place securities that they are unable to sell to the public in an investment account or with an affiliate if the offering is undersubscribed.

Referral and Advisory Arrangements. Rule 5141 may permit the establishment of certain referral and advisory arrangements between a member which is participating in a fixed price offering and another entity that is not a broker-dealer which is also participating in the offering if it does not, directly or indirectly, confer a reduced price in respect of any securities sold in the offering and otherwise complies with NASD Rule 2420 (Dealings with Non-Members).⁶ Aside from a limited exception,⁷ members generally viewed such arrangements as having been prohibited by the Papilsky Rules.

Bass, Berry & Sims PLC's Corporate Finance/1933 Act Subgroup monitors and advises on developments relating to corporate finance matters including initial public offerings, follow-on public offerings, Rule 144A offerings and private placements of equity and debt securities. If you have any questions regarding the issues addressed in this alert, or if you would like to set up a meeting with us and your management team or Board of Directors regarding these developments, please feel free to communicate with your regular contacts in our Corporate and Securities Group or any of the attorneys in our Subgroup listed below.

John A. Good	(901) 543-5901	jgood@bassberry.com
Laura R. Brothers	(615) 742-7705	lbrothers@bassberry.com
Helen W. Brown	(901) 543-5918	hwbrown@bassberry.com
Wes Scott	(901) 543-5983	wscott@bassberry.com

⁵ Similar to the Papilsky Rules, securities offered for sale in a fixed price offering are presumed saleable for purposes of FINRA Rule 5141 "if the securities immediately trade in the secondary market at a price or prices which are above the stated public offering price."

⁶ As part of its process to develop a new consolidated rulebook, FINRA has sought comments on proposed FINRA Rule 2040 which, if adopted, would streamline the provisions of various rules promulgated by FINRA, the National Association of Securities Dealers, Inc. and the New York Stock Exchange regarding payments to persons not registered with FINRA.

⁷ See Interpretive Letter to Dana Fleischman issued November 24, 2003 (permitting the payment of an advisory or referral fee between a participating and non-participating broker-dealer) which is [available here](#).

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