

## Effect of New FINRA Anti-Spinning Rule on Private Funds

Elliott Curzon, Jennifer Wood, and Sean Murphy of Dechert LLP

Effective May 27, 2011, new FINRA <sup>[1]</sup> Rule 5131 will prohibit *quid pro quo* allocations and "spinning" of new issues to favored customers, <sup>[2]</sup> such as certain executive officers and directors of potential investment banking clients, in exchange for investment banking business. <sup>[3]</sup> Although Rule 5131 only applies to FINRA member firms, it will affect private funds and managers when FINRA members ask for certain representations and additional information from private funds and their investors in order to ensure that the FINRA members are not allocating New Issues in violation of the Rule.

### Spinning Prohibition

Rule 5131 specifically prohibits FINRA member firms, or any person associated with a FINRA member firm, from allocating New Issues to any account in which an executive officer or director of a public company <sup>[4]</sup> or a covered non-public company <sup>[5]</sup>, or a person materially supported <sup>[6]</sup> by any such executive officer or director ("Covered Persons"), have a beneficial interest: <sup>[7]</sup>

- if the company is currently an investment banking services client of the FINRA member, or the FINRA member has received compensation from the company for investment banking services in the past 12 months;
- if the person responsible for making allocation decisions knows or has reason to know that the FINRA member intends to provide, or expects to be retained by the company for, investment banking services within the next three months; or
- on the express or implied condition that such executive officer or director, on behalf of the company, will retain the FINRA member for the performance of future investment banking services

### Exceptions

To the extent that investors in a private fund are Covered Persons, Rule 5131 may preclude the private fund from participating in New Issues; however, the Rule permits allocation of New Issues to accounts in which the aggregate beneficial interests of Covered Persons do not exceed 25% of the account. Accordingly, private funds will not be restricted from investing in New Issues so long as the beneficial interests of Covered Persons do not exceed 25% of the fund. In the event the beneficial interests of Covered Persons exceed 25% of the fund, the fund must identify the company employing each Covered Person and determine whether the conditions of Rule 5131 apply.

Similarly to FINRA Rule 5130 (the Rule that prohibits the sale of New Issues to certain securities industry insiders or "restricted persons"), new Rule 5131 also exempts from its prohibitions U.S. registered investment companies, common trust fund accounts, insurance company accounts, certain publicly traded entities listed or eligible to be listed on a U.S.

exchange, non-U.S. investment companies, ERISA plans, state or municipal benefits plans, 501(c)(3) organizations and 414(e) church plans.

### **Practical Considerations**

Rule 5131 allows FINRA members to rely on written representations obtained within the prior 12 months from account owners about their status as executive officers or directors and their employers. Funds seeking to invest in New Issues will likely be required by FINRA members to make such representations and provide relevant information. As with the representations required in connection with Rule 5130 restricted person issues, funds should consider whether to add to their subscription documents or investor questionnaires questions relating to an investor's employer and position, to enable the fund to qualify for a New Issue allocation consistent with the requirements of Rule 5131.

---

### **Elliott Curzon, Partner, [elliott.curzon@dechert.com](mailto:elliott.curzon@dechert.com)**

Elliott R. Curzon advises broker-dealers on issues regarding the Securities Exchange Act of 1934, the U.S. Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), the New York Stock Exchange, and state and other SRO rules.

These matters include registration, compliance, supervision, licensing, sales practices, suitability, trading, clearance, settlement, net capital, transfer agent, operations, commissions, compensation, contractual relationships, and advertising, as well as SEC and FINRA examinations and enforcement actions.

### **Jennifer Wood, Partner, [jennifer.wood@dechert.com](mailto:jennifer.wood@dechert.com)**

Jennifer Wood focuses her practice on advising UK, U.S., European and Asian financial services firms, investment managers and investment funds on U.S. regulatory matters, including investment adviser and fund registration and compliance matters.

Ms. Wood provides advice to fund managers and other institutions on the establishment, structuring and maintenance of alternative investment funds. She also advises U.S. registered investment companies and investment advisers and has substantial experience advising such firms in connection with mergers and acquisitions.

### **Sean Murphy, Associate, [sean.murphy@dechert.com](mailto:sean.murphy@dechert.com)**

Sean R. Murphy focuses his practice on financial services matters. Prior to joining Dechert, he worked in the Litigation, Employment and Regulatory Affairs group of a large investment management firm, where he focused on complex securities class actions, FINRA arbitrations and responses to regulatory requests.

Mr. Murphy was a Dechert summer associate in 2008.

## Dechert LLP

**Dechert** (<http://www.dechert.com/>) is a leading international law firm with 21 offices in the United States, Europe and Asia. Founded in 1875, the firm has grown to over 800 lawyers allowing it the resources to deliver seamless, high-quality legal services to clients wherever the firm does business.

The firm's clients' success determines its success. The firm ensures this by collaborating closely with them and working diligently and efficiently to help clients achieve their goals. Guided by a team-oriented philosophy, the firm encourages ongoing communication with clients to ensure that it understands their objectives and can easily accommodate their changing needs. With in-depth industry knowledge and legal experience, the firm is able to identify the most complicated issues and focus on what matters most to its clients.

[1] Financial Industry Regulatory Authority, Inc.

[2] See FINRA Regulatory Notice 10-60, Approval of New Issue Rule (November 2010), *available at* <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122490.pdf>. The Securities and Exchange Commission previously approved Rule 5131 on September 29, 2010. See SEC Release No. 34-63010, 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") (September 29, 2010), *available at* <http://www.sec.gov/rules/sro/nasd/2010/34-63010.pdf>

[3] The new Rule also addresses the conduct of member firms and associated persons in connection with book-building, new issue pricing, penalty bids, trading and waivers of lock-up agreements; however, the effect of those provisions is limited to broker-dealer operations. The new Rule 5131 defines "New Issue" using the definition from FINRA Rule 5130, which generally includes IPOs of equity securities.

[4] "Public company" is defined by Rule 5131 and means any company that is registered under Section 12 of the Securities Exchange Act of 1934 or files periodic reports pursuant to Section 15(d) thereof.

[5] "Covered non-public company" is defined by Rule 5131 and means any non-public company (including non-U.S. companies) 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.

[6] "Material support" is defined by Rule 5131 and means 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.

[7] "Beneficial interest" is defined by Rule 5130 and means 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.

Material in this work is for general educational purposes only, and should not be construed as legal advice or legal opinion on any specific facts or circumstances. For legal advice, please consult your personal lawyer or other appropriate professional. Reproduced with permission from Dechert LLP. This work reflects the law at the time of writing April 2011.