

Effect of New FINRA Anti-Spinning Rule on Private Funds

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Effective May 27, 2011, new FINRA ^[1] Rule 5131 will prohibit *quid pro quo* allocations and "spinning" of new issues to favored customers, ^[2] such as certain executive officers and directors of potential investment banking clients, in exchange for investment banking business. ^[3] 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 ^[4] or a covered non-public company ^[5], or a person materially supported ^[6] by any such executive officer or director ("Covered Persons"), have a beneficial interest: ^[7]

- 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.

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[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.

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