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New FINRA “New Issues” Allocation Rule

To: Clients and Friends of Tannenbaum Helpern Syracuse & Hirschtritt LLP¹

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I. Introduction

The Financial Industry Regulatory Authority (“FINRA”) recently enacted a new rule that may require advisers to hedge funds and other entities to revise their initial public offering (“IPO”) or “new issue” allocation compliance and reporting policies. On September 29, 2010, the Securities and Exchange Commission (“SEC”) approved FINRA Rule 5131 (New Issue Allocations and Distributions) in order to address abuses relating to transactions involving new issues. The goal of this rule is to improve public confidence in the IPO process by implementing new regulatory requirements regarding the offering and trading of a new issue allocation.² It seeks to accomplish this goal by limiting the ability of issuers to engage in new issue trades with certain restricted types of investors, namely those who are directors and officers of companies that are investment banking clients of broker-dealers. On November 29, 2010, FINRA announced that Rule 5131 had been finalized and will take effect on May 27, 2011.³

II. Background

Although Rule 5131 (and all other FINRA rules) governs only FINRA members (“FINRA members” or “members” for the purposes of this memo, and generally all FINRA-registered broker-dealers), this rule will impact hedge funds because hedge funds often receive new issue allocations and may have investors who are restricted from participating in new issue transactions pursuant to the new rule. Rule 5131 incorporates

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² See FINRA Regulatory Notice 10-60, Approval of New Issue Rule (“FINRA Regulatory Notice 10-60”), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122490.pdf>.

³ See FINRA Regulatory Notice 10-60.

the “new issue” definition found in FINRA Rule 5130(i)(9) by reference, which defines them as “any initial public offering of an equity security as defined in Section 3(a)(11) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”) made pursuant to a registration statement or offering circular.” This definition excludes certain transactions from the definition of “new issue” including:

1. offerings made pursuant to an exemption under Sections 4(1), 4(2) or 4(6) of the Securities Act of 1933 (the “Securities Act”) or Securities Act Rule 504 if those securities are “restricted securities” under Rule 144(a)(3), Rule 144A, Rule 505 or Rule 506 under the Securities Act;
2. offerings of exempted securities as defined in Section 3(a)(12) of the Exchange Act and rules thereunder;
3. offerings of securities of a commodity pool operated by a commodity pool operator as defined under Section 1(a)(5) of the Commodity Exchange Act (“CEA”);
4. rights offerings, exchange offerings, or offerings pursuant to a merger or acquisition;
5. offerings of investment grade asset-backed securities;
6. offerings of convertible securities;
7. offerings of preferred securities;
8. offerings of shares of investment companies registered under the Investment Company Act of 1940 (the “Company Act”);
9. offerings of securities that have a preexisting market outside of the U.S. (and therefore only applies to non-U.S. IPOs if there is already a market for those new issues); and
10. offerings of certain business development companies as defined in Section 2(a)(48) of the Company Act, a direct participation program as defined in Rule 2310(a), or a real estate investment trust as defined in Section 856 of the Internal Revenue Code.⁴

If a fund purchases “new issues,” it will have to comply with Rule 5131, a rule designed to increase consumer confidence in the IPO process and decrease industry-wide abuses, as detailed below.

III. Types of Prohibited Activity under Rule 5131

A. *Spinning*

“Spinning” generally refers to the practice of FINRA members allocating new issue shares to certain restricted clients, namely executive officers and directors of companies who are current (or certain former or prospective) investment banking clients of a member. As these types of clients are often in a position to hire employees of FINRA members on behalf of their companies, the allocation of new issue shares to these

⁴ See FINRA Rule 5130(i)(9).

clients (potentially via their hedge fund investments) can create the appearance of impropriety. For this reason, the new FINRA rule seeks to outlaw the process of “spinning” by prohibiting certain transactions between FINRA members and certain restricted clients. It also prohibits the allocation of new issue shares in three specific circumstances to an account (for the purposes of this memo, an investment fund or hedge fund) of any “restricted person” (as defined below) who has a beneficial interest in that account.⁵ This anti-“spinning” provision would apply to any account in which any of the following three categories of “restricted persons” have a beneficial interest:

1. an executive officer or director of a public company;
2. an executive officer or director of a “covered non-public company”⁶; or
3. a person “materially supported” by an executive officer or director of a public company or covered non-public company.⁷

The three circumstances in which a FINRA member may not allocate new issue shares to an account or fund in which a restricted person holds a beneficial interest are:

1. if the company [i.e. a company referred to in either 1, 2 or 3 immediately above] 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;
2. 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 three months; or
3. on the express or implied condition that such [restricted person], on behalf of the company, will retain the member for the performance of future investment banking services.⁸

While these limited circumstances and categories of beneficial interest owners do restrict the types of new issue transactions that a hedge fund can take part in, Rule 5131 does provide three exceptions to these anti-“spinning” provisions. First, FINRA provides a *de minimis* exception for certain types of accounts or funds. To qualify for the exception under Rule 5131(b)(3), the recipient account must be one in which the “collective beneficial interests of executive officers and directors of the company and persons materially supported by such executive officers and directors in the aggregate do

⁵ A “beneficial interest,” as defined in FINRA Rule 5130, is any “economic interest, such as the right to share in gains and losses.” This definition does not include any management or performance-based fee for operating a collective investment account or any other fees for acting in a fiduciary capacity.

⁶ A “covered non-public company” refers to any non-public company that satisfies one of the following three 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.” SEC Release No. 34-63010.

⁷ SEC Release No. 34-63010. There is no definition provided for “materially supported.”

⁸ SEC Release No. 34-63010 (Sept. 29, 2010).

not exceed [twenty-five] (25) percent of such account.” If the restricted persons’ collective beneficial interests in a given account do exceed twenty-five (25) percent of that account, then that fund would not qualify for this exception.

Rule 5131(b)(3) also provides a second exception from “spinning” prohibitions for allocations made to certain accounts. These exempt accounts, as detailed in Rule 5130(c), include 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 benefit plans, 501(c)(3) organizations and 414(e) church plans. A new issue allocation to any of these companies would not trigger the Rule 5131 provisions. Finally, Supplementary Material .01 to Rule 5131 notes that the anti-“spinning” provisions do not apply to allocations directed “in writing by the issuer, its affiliates, or selling shareholders – so long as the FINRA member has no involvement or influence, directly or indirectly, in the allocation decisions of the issue, its affiliates or selling shareholders with respect to such issuer-directed allocations.” If, however, none of these exceptions are available, a hedge fund may not participate in any new issue allocations as it would be considered a restricted account.

B. Flipping

The new FINRA rule also seeks to end abuses relating to “flipping,” or the practice of selling shares purchased through a new issue allocation shortly after acquiring them. Rule 5131(e)(4) defines “flipping” as the resale of new issue allocations into the secondary market within thirty (30) days following the offering date of those shares.⁹ In an effort to curtail abuses pertaining to “flipping,” FINRA stated in Rule 5131(c) that no members firms or their associated persons can seek to or (directly or indirectly) recoup any portion of a commission or credit paid to an associated person for selling shares of a new issue that have been “flipped” to a customer. Rule 5131(c) also requires members to record and maintain information dealing with any penalties assessed pertaining to “flipped” allocations.

IV. Compliance with Rule 5131

Hedge funds (as well as all FINRA members) will soon have to reevaluate their compliance structures in light of the new proposals found in Rule 5131. In terms of the anti-“spinning” provisions, Supplementary Material .02 to Rule 5131 allows all members and funds to rely on written representations provided by the beneficial owner of the relevant account (or any person authorized to represent that beneficial owner) as to whether the owner is a restricted person and, if so, the companies on whose behalf that owner serves. However, members and funds may only rely on those representations made within the last twelve (12) months as to whether that beneficial owner is a “restricted

⁹According to FINRA Regulatory Notice 10-60, most syndicate selling agreements provide that an underwriter can impose a “penalty bid” on any syndicate members who “flip” new issue allocations in order to reclaim the selling concession for those allocations.

person.” This reliance on representations by the beneficial owner must be made affirmatively by that owner in the first instance. However, these representations may be updated annually through the use of negative consent letters.¹⁰ In addition, no member may rely on any representation if that member either believes or has reason to believe that the statement is inaccurate. Under Rule 5131, FINRA now requires all members to maintain a copy of all of its records and information pertaining to whether any accounts are eligible to receive allocations of new issues for at least three (3) years after the member’s allocation of new issues to that account.

V. What Should be Done Now?

As noted above, FINRA Rule 5131 becomes effective on May 27, 2011. Prior to that date, hedge funds can begin to prepare for these changes to take effect. First, in order to comply with the anti-“spinning” provisions, funds should contact their investors in order to acquire any additional representations to determine if they are “restricted persons” pursuant to Rule 5131. Second, any funds that invest in new issues should begin to revise their subscription documents and annual new issue questionnaires in order to obtain these representations from their investors and to determine if these investors are restricted persons under Rule 5131(b). If a beneficial owner falls into one of the three restricted categories, the fund should collect more information regarding the investor’s company affiliations.¹¹ Finally, all funds dealing with these issues should be careful to monitor whether the percentage of ownership of the fund beneficially owned by restricted persons rises above twenty-five (25) percent. If it does, the fund will not be able to take advantage of the *de minimis* “spinning” exception and may not be acquire allocations of new issues until the ownership percentage drops below the threshold again. Funds should begin changing their structural and operational procedures in order to comply with the Rule 5131 recordkeeping obligations. Please note that these suggestions are not all inclusive; rather, they represent certain basic changes that should be made by all funds that engage in new issue transactions.

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The transition to new rules pertaining to new issue allocations presents all FINRA members as well as many hedge funds with many challenges. However, proper preparation and adjustments will make this transition much easier. Please feel free to contact us if you would like us to assist you in revising your subscription documents and/or other fund materials prior to the May 27, 2011 deadline, or if you have any other questions pertaining to these new rules.

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¹⁰ FINRA Regulatory Notice 10-60.

¹¹ It is also important to note that these representations must be updated annually, as Rule 5131 only allows for FINRA members to rely on the representations of beneficial owners obtained over the prior twelve months.