

New Issue Allocations and Distributions

SEC Approves a Limited Exception From FINRA Rule 5131(b) to Permit Firms to Rely Upon a Written Representation From Certain Unaffiliated Private Funds

Effective Date: February 3, 2014

Executive Summary

The SEC approved amendments to Supplementary Material .02 (Written Representations) to FINRA Rule 5131 (New Issue Allocations and Distributions) to provide a limited exception to facilitate firm compliance when allocating shares of a new issue to the accounts of certain unaffiliated private funds.¹

The text of the amendments can be found in the online FINRA Manual at www.finra.org/finramanual.

Questions regarding this *Notice* should be directed to Racquel Russell, Associate General Counsel, Office of General Counsel, at (202) 728-8363.

Background and Discussion

FINRA Rule 5131 (New Issue Allocations and Distributions) addresses potential abuses in the allocation and distribution of “new issues.”² Rule 5131(b) addresses the practice of “spinning,” where a firm allocates shares of a new issue to the account of an executive officer or director of a public company³ or a covered non-public company⁴ (and materially supported persons)⁵ as an award for retaining the firm for investment banking business.⁶ The rule’s spinning prohibitions generally apply to allocations to executive officers and directors:

1. whose companies are current or recent (within the past 12 months) investment banking clients;
2. where the person responsible for making the allocation decision knows or has reason to know that the firm intends to provide or expects to be retained for investment banking services by the company within the next three months; or

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Notice Type

- ▶ Rule Amendment

Suggested Routing

- ▶ Compliance
- ▶ Corporate Financing
- ▶ Legal
- ▶ Operations
- ▶ Senior Management
- ▶ Syndicate
- ▶ Underwriting

Key Topics

- ▶ Allocations
- ▶ Conflicts of Interest
- ▶ Initial Public Offerings
- ▶ Investment Banking
- ▶ New Issues
- ▶ Public Offerings
- ▶ Spinning

Referenced Rules

- ▶ FINRA Rule 5130
- ▶ FINRA Rule 5131
- ▶ Investment Advisers Act Section 202

3. on condition that the executive officer or director, on behalf of the company, will retain the firm for the performance of future investment banking services.

Since the rule's inception, firms have been permitted to rely upon a written representation obtained within the prior 12 months from the beneficial owner of an account, or a person authorized to represent the beneficial owner, as to whether the beneficial owner is an executive officer or director (or materially supported person) and, if so, the name of the company on whose behalf the executive officer or director serves. FINRA believes that firms have found this provision useful in cases where the potentially covered person is a direct beneficial owner of the account that may receive the new issue allocation.

However, firms have raised concerns regarding the difficulty involved in obtaining, tracking and aggregating information from accounts regarding indirect beneficial owners, such as participants in a fund of funds, for use in determining an account's eligibility to receive a new issue allocation.⁷ To address these concerns, FINRA has amended Rule 5131 to provide an exception, codified as Rule 5131.02(b) (Indirect Beneficial Owners), to ease compliance with the spinning provision in situations where the ability of an underwriter to confer any meaningful financial benefit to a particular investor by allocating new issue shares to the account is impracticable. Specifically, the new exception permits firms to rely upon a written representation obtained within the prior 12 months from a person authorized to represent an account that does not look through to the beneficial owners of any unaffiliated private fund invested in the account, except for beneficial owners that are control persons of the investment adviser to the private fund, that the unaffiliated private fund:

- ▶ is managed by an investment adviser;
- ▶ has assets greater than \$50 million;
- ▶ owns less than 25 percent of the account and is not a fund in which a single investor has a beneficial interest of 25 percent or more; and
- ▶ was not formed for the specific purpose of investing in the account.

Supplementary Material .02(b) further provides that an "unaffiliated private fund" is a "private fund," as defined in Section 202(a)(29) of the Investment Advisers Act,⁸ whose investment adviser does not have a control person⁹ in common with the investment adviser to the account. A control person of an investment adviser is a person with direct or indirect "control" over the investment adviser, as that term is defined in Form ADV.

As is currently the case, a firm may rely upon a written representation pursuant to Supplementary Material .02 unless it believes, or has reason to believe, that the representation is inaccurate, and must maintain a copy of all records and information relating to whether an account is eligible to receive an allocation of the new issue in its files for at least three years following the firm's allocation to that account.

Amended Rule 5131 becomes effective on February 3, 2014. For more information, see FINRA rule filing [SR-FINRA-2013-037](#).

Endnotes

1. See Securities Exchange Act Release No. 70957 (November 27, 2013); 78 FR 72946 (December 4, 2013) (Order Approving SR-FINRA-2013-037).
2. Rule 5131 provides that “new issue” has the same meaning as in Rule 5130(i)(9), which generally includes any initial public offering of an “equity security,” as defined in Section 3(a)(11) of the Exchange Act, made pursuant to a registration statement or offering circular, with enumerated exceptions.
3. A “public company” is any company that is registered under Section 12 of the Exchange Act or files periodic reports pursuant to Section 15(d) thereof. See Rule 5131(e)(1).
4. The rule defines a “covered non-public company” as any non-public company 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. See Rule 5131(e)(3).
5. “Material support” means directly or indirectly providing more than 25 percent 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. See Rule 5131(e)(6).
6. “Investment banking services” include, without limitation, acting as an underwriter, participating in a selling group in an offering for the issuer or otherwise acting in furtherance of a public offering of the issuer; acting as a financial adviser in a merger, acquisition or other corporate reorganization; providing venture capital, equity lines of credit, private investment, public equity transactions (PIPEs) or similar investments or otherwise acting in furtherance of a private offering of the issuer; or serving as placement agent for the issuer. See Rule 5131(e)(5).
7. For example, firms have noted that broker-dealers normally do not know the identity of the beneficial owners of the fund of funds invested in the account.
8. Section 202(a)(29) of the Investment Advisers Act of 1940 defines the term “private fund” as an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3) (Investment Company Act), but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act.
9. A control person of an investment adviser is a person with direct or indirect “control” over the investment adviser, as that term is defined in Form ADV.