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New FINRA Rule 5131: Implications for Fund Managers

Written by Jeffrey D. Collins, Tiffany Ann Ford

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On May 27, 2011, new Rule 5131 (New Issue Allocations and Distributions) of the Financial Industry Regulatory Authority, Inc. ("FINRA") will go into effect. This new rule is intended to address certain abuses in the allocation and distribution of new issues and specifically prohibits, among other things, "spinning." The full text of the rule can be found on the FINRA website. Rule 5131 does not replace the existing new issues rule (Rule 5130), but instead creates an additional set of requirements.

Although FINRA Rule 5131 only applies directly to FINRA members, investment funds that participate in new issues will likely be impacted. In order to comply with the new rule, broker-dealers that are subject to FINRA rules will require certain representations from a fund before the fund will be allowed to participate in initial public offerings ("new issues").

Prohibition on Spinning

FINRA members, and any person associated with a FINRA member, are prohibited from allocating shares of a new issue to any account (including a fund) in which an executive officer or director of a public company or a "covered non-public company," 1 or a person materially supported by such executive officer or director (each a, "Restricted Person"), has a beneficial interest under the following circumstances:

- If the company 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;
- 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
- On the express or implied condition that such executive officer or director, on behalf of he company, will retain the member for the performance of future investment banking services.

Considerations for Investment Funds

Before allocating a new issue to a fund, FINRA member broker-dealers will need to confirm that the underlying investors in the fund are not Restricted Persons. If the collective beneficial ownership interests of Restricted Persons exceed 25% of such fund in the aggregate, the fund will be unable to participate in the new issue. However, if the beneficial ownership interests of Restricted Persons exceed 25% of the fund, the fund may still participate if it implements "cut-back" procedures with respect to the investment in the new issue such that Restricted Person participation in the new issue does not exceed 25%. Managers wishing to make use of cut-back provisions should review whether the operating documents of their fund are set up to allow for such cut-backs.

To facilitate compliance with FINRA Rule 5131, managers of funds that participate in new issues should (i) revise their subscription documents to include representations regarding Restricted Person status and a listing of the companies for which the Restricted Person acts as an executive officer or director, and (ii) contact existing investors to obtain written representations as to whether or not the investor is a Restricted Person and, if so, the companies for which the Restricted Person acts as an executive officer or director. Such representations should be updated annually, which may be done through the use of a negative consent letter.

1 According to Rule 5131, "[a] 'covered non-public company' means any non-public company with: (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.

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