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## SEC Approves Amendment to FINRA IPO Allocation Rule 5131, Easing Compliance for Fund Investors

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**On November 27, 2013, the Securities and Exchange Commission approved a change (the “Amendment”) to FINRA’s IPO allocation rule 5131. The Amendment allows a fund-of-funds to rely on a written representation from an unaffiliated private fund that does not look through to its beneficial owners, provided that the unaffiliated private fund meets certain other indicia of independence that are described in this publication.**

### Introduction

On November 27, 2013, the Securities and Exchange Commission (“SEC”) approved a change (the “Amendment”) to FINRA’s IPO allocation rule 5131 (the “Rule”).<sup>1</sup>

<sup>1</sup> See SEC Release 34-70957, “Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Amend FINRA Rule 5131 (New Issue Allocations and Distributions)” (November 27, 2013) (the “Adopting Release”). SEC Releases are available at the SEC’s Internet website: [www.sec.gov](http://www.sec.gov). For more information regarding the IPO allocation rule, please see: “FINRA Rule 5131: FINRA Proposes Delaying or Eliminating Certain Provisions” (April 22, 2011), available at <http://www.shearman.com/en/newsinsights/publications/2011/04/finra-rule-5131-finra-proposes-delaying-or-eliminating>; “FINRA New Issue (IPO) Allocation Rule to Take Effect May 27, 2011; Investment Funds Must Now Consider Compliance” (January 14, 2011), available at <http://www.shearman.com/en/newsinsights/publications/2011/01/finra-new-issue-ipo-allocation-rule-to-take-effect>; and, “SEC Approves FINRA Rule Regarding IPO Allocation Practices”, (October 13, 2010), available at <http://www.shearman.com/en/newsinsights/publications/2010/10/sec-approves-finra-rule-regarding-ipo-allocation>. Additional materials regarding the IPO allocation rule are available at Shearman & Sterling’s Internet website, [www.shearman.com/](http://www.shearman.com/).

The Amendment allows a fund-of-funds to rely on a written representation from an unaffiliated private fund that does not look through to its beneficial owners, provided that the unaffiliated private fund meets certain other indicia of independence, namely that the unaffiliated private fund must: (a) be managed by an investment adviser; (b) have assets greater than \$50 million; (c) own less than 25% of the account and is not a fund in which a single investor has a beneficial interest of 25% or more; and (d) not have been formed for the specific purpose of investing in the account.<sup>2</sup>

In the Adopting Release, the SEC states that FINRA will announce the effective date of the proposed rule change in a Regulatory Notice<sup>3</sup> to be published no later than 60 days following the SEC's November 27 approval. The effective date will be no later than 120 days following the SEC's approval.

### Summary of the Spinning (and Other) Provisions of Rule 5131

**"Spinning" by FINRA-Member Broker-Dealers to Executive Officers and Directors of Investment Banking Clients is Prohibited**

Under the Rule, a FINRA-member broker-dealer is prohibited from allocating "new issue securities"<sup>4</sup> to any account – which includes an investment fund or other collective investment vehicle – if an executive officer or director of a "public company" or "covered non-public company"<sup>5</sup> has a beneficial economic interest, (including the right to share in gains or losses) in the account, if any of the following are true:

1. the company is currently an investment banking client of the member;
2. in the 12 month period *prior* to the allocation, the member received compensation from the company for investment banking services;
3. the FINRA member expects to provide or be retained for investment banking services in the three month period following the allocation; or
4. the allocation is made on the condition that such executive officer or director, on behalf of the company, retain the member for performance of future investment banking services.

<sup>2</sup> The definition of "unaffiliated private fund" and the independence criteria are more fully described below.

<sup>3</sup> FINRA Regulatory Notices are available on FINRA's Internet website, [www.finra.org](http://www.finra.org).

<sup>4</sup> "New issue securities" is a term defined to mean "any initial public offering of an equity security made pursuant to a registration statement or offering circular". As a practical matter, this definition includes all US-registered IPOs. The definition of "new issue" also contains a number of excluded offering types: (i) private placements, (ii) sales of certain restricted securities, including Rule 144A offerings, (iii) offerings of investment grade asset-backed securities, (iv) offerings of convertible securities, (v) offerings of securities that have a pre-existing market outside the United States, and (vi) offerings of registered investment companies. The definition of "new issue" does not by its terms exclude non-US IPOs (other than IPOs of companies with a pre-existing market outside the United States).

<sup>5</sup> Under the Rule, a "public company" is a US reporting company, meaning any company that is registered under Section 12 of the Securities Exchange Act of 1934 or files periodic reports pursuant to Section 15(d). 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. We note that there is no exemption from the definition of "covered non-public company" for investment management firms, so that a fund's management company can itself be a "covered non-public company."

**Exceptions to the Spinning Prohibition: Issuer-Directed Shares, General Exceptions Matching Those Found in the Existing “New Issue” Rule 5130, and the de minimis Exception**

*Issuer-Directed Shares are Exempt*

The spinning prohibition does not apply to allocations of issuer-directed shares, provided that the member has no involvement or influence in the issuer’s allocation decisions.

*The Rule Shares all of the General Exemptions Found in the New Issue Rule*

The Rule incorporates by reference virtually all of the exceptions from the restrictions imposed by Rule 5130, the New Issue Rule.<sup>6</sup> These accounts include:

- US-registered investment companies;
- Common trust fund accounts;
- Insurance company accounts;
- Certain publicly traded entities listed or eligible to be listed on a US exchange;
- Non-US investment companies that are eligible for sale to the public outside the United States;
- ERISA plans;
- State or municipal benefits plans;
- A tax exempt charitable organization under Section 501(c)(3) of the Internal Revenue Code; and
- A church plan under Section 414(e) of the Internal Revenue Code.

*The “25% de minimis” Test for Collective Investment Accounts, Including Private Investment Accounts*

Rule 5131 permits allocations of new issues to an account, including a collective investment vehicle such as a fund, in which the collective beneficial interests of executive officers and directors of a particular company, and persons materially supported by such executive officers and directors, in the aggregate, are no greater than 25 percent of such account.<sup>7</sup> Under the Rule, this “de minimis” exception is both a threshold exception for accounts that by their ownership meet the threshold, and also an allocation tool, permitting a collective investment vehicle to affirmatively limit the profit and loss from new issue securities allocated to covered persons of a particular company to no more than 25 percent through an affirmative allocation procedure.

<sup>6</sup> FINRA’s New Issue Rule 5130 prohibits the sale of new issue securities to accounts in which a “restricted person” (generally, securities industry insiders) has a beneficial interest. For more information regarding the New Issue Rule, please see: “SEC Approves Amendments to NASD “New Issue Rule” 2790” (August 1, 2005), available at <http://www.shearman.com/en/newsinsights/publications/2005/08/sec-approves-amendments-to-nasd-new-issue-rule-2>; and, “SEC Approves Minor Amendments to FINRA “New Issue” Rule 2790 Relating to IPO Directed Share Programs” (August 9, 2007), available at <http://www.shearman.com/en/newsinsights/publications/2007/08/sec-approves-minor-amendments-to-finra-new-issue>. Additional information regarding FINRA’s New Issue Rule 5130 is available at Shearman & Sterling’s Internet website, [www.shearman.com](http://www.shearman.com).

<sup>7</sup> By contrast, the analogous exemption under Rule 5130 applies to accounts in which restricted persons have an aggregate beneficial interest of no greater than 10 percent: see FINRA Rule 5130(c)(4).

Compliance with the Spinning Rule Requires the Broker-Dealer Making the Allocation to Receive a Representation from Accounts Seeking an Allocation.

To facilitate compliance with the spinning prohibition, the Rule permits members to rely on written representations obtained within the prior 12 months from the beneficial owner(s) of an account as to whether such beneficial owner(s) is an executive officer or director (or person materially supported by an executive officer or director) and, if so, the company or companies on whose behalf such executive officer or director serves. The initial representation must be an affirmative representation, but subsequently may be updated annually through the use of negative consent letters. FINRA has reminded its members that they may not rely upon any representation that they believe, or have reason to believe, is inaccurate.

It is this provision of the Rule that is changed by the Amendment.

### Summary of the Rule: Other Requirements in Respect of the Conduct and Pricing of IPOs

The Rule implements a number of rules impacting IPO allocation practices in addition to the “spinning” prohibition. Those regulations include:

- Extension of the lock-up to issuer-directed shares: Any lock-up agreement or other restriction on the transfer of the issuer’s shares by officers and directors of the issuer entered into in connection with a new issue must provide that such restrictions will also apply to any issuer-directed shares received by such officers or directors.
- Pre-conditions to lock-up waiver: In addition, the agreement must require that at least two business days prior to the release of any lock-up, the lead manager will notify the issuer and make an announcement through a major news service, except where the release is effected solely to permit a transfer of securities not for consideration and where the transferee has agreed in writing to be bound by the same lock-up agreement terms.
- Quid Pro Quo Allocations: A prohibition on the offer of new issue securities, or the threat to withhold new issue securities, as consideration or inducement for the receipt of compensation that is “excessive” in relation to the services provided to the customer by the FINRA member.
- Flipping: A prohibition on FINRA members from penalizing registered representatives of whose customers have “flipped” a new issue, unless a penalty bid has been imposed on the member by the managing underwriter.
- Pricing and Trading Practices—report of indications of interest: The book-running lead manager must provide to the issuer a report of indications of interest, including the names of interested institutional investors and the number of shares indicated by each, and a report of aggregate demand from retail investors. After the IPO settlement date, the book-running lead manager must provide a report of the final allocation of shares.
- Shares trading at a premium to the IPO price returned by a purchaser: The agreement among syndicate members must provide that, to the extent not inconsistent with Regulation M, shares trading at a premium to the IPO price returned by a purchaser to a syndicate member after trading commences will be allotted to the syndicate short position, or, if no short position exists, the member must offer returned shares at the public offering price to unfilled customers’ orders pursuant to a random allocation methodology, or sell returned shares on the secondary market and donate profits from the sale to an unaffiliated charitable organization with the condition that the donation be treated as an anonymous donation to avoid any reputational benefit to the member.

- **Market Orders:** No FINRA member may accept a market order for the purchase of shares of a new issue in the secondary market prior to the commencement of trading of such shares in the secondary market. Market orders may be placed after the commencement of secondary market trading in the IPO.

## The Amendment

The Amendment Allows a Fund-of-Funds to Rely on a Written Representation from an Unaffiliated Private Fund that Does Not Look Through to its Beneficial Owners

The Amendment permits a fund-of-funds to rely upon a written representation obtained within the prior 12 months from an account that does not look through to the beneficial owners of any “unaffiliated private fund”<sup>8</sup> invested in the account, provided that such unaffiliated private fund:

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

In proposing the Amendment, FINRA excluded beneficial owners that are control persons of the investment adviser to the applicable unaffiliated private fund. The account (e.g., fund-of-funds) does, therefore, need to look through to its beneficial owners to the extent that such beneficial owners are control persons of the applicable unaffiliated private fund.<sup>9</sup>

The Purpose of the Amendment is to Provide Relief for Funds-of-Funds that are Seeking to Determine Compliance with the Rule

As noted above, the Rule requires a collective investment vehicle, such as a fund, to survey its beneficial owners in order to determine whether any of those owners is a “covered person” for purposes of the IPO allocation rule, and/or to determine whether the nature of such owners and such ownership is such that the “de minimis” exemption described above may apply. In its release proposing the Amendment, FINRA noted that it understands the difficulty of determining beneficial ownership in certain circumstances. Specifically, FINRA noted that it “understands that members (and their customers) have had difficulty obtaining, tracking and aggregating information from funds regarding indirect beneficial owners, such as participants in a fund of funds, for use in determining an account’s eligibility for the de minimis exception and that this has resulted in compliance difficulties and restrictions, including 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.”<sup>10</sup> FINRA goes on to note further that in the fund-of-funds or “nested” funds context, the concerns that the Rule is intended to address are not generally present.<sup>11</sup>

<sup>8</sup> An unaffiliated private fund is a “private fund,” as defined in Section 202(a)(29) of the Investment Advisers Act, whose investment adviser does not have a control person 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.

<sup>9</sup> See the Adopting Release at text accompanying footnotes 21 and 22.

<sup>10</sup> See “Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change To Amend FINRA Rule 5131 (New Issue Allocations and Distributions)”, 78 Fed. Reg. 175 55322 (September 10, 2013) (the “Proposing Release”) at p. 55323.

### Timing of Effectiveness

In the Adopting Release, the SEC states that FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following the SEC's November 27 approval. The effective date will be no later than 120 days following the SEC's approval.

### Conclusion

The Amendment is a welcome addition to the Rule, because it permits FINRA members to allocate IPO securities to an additional group of investors, where such investors in the past were generally unable to conduct the diligence required in order to make the required representation of eligibility. FINRA members are hopeful that additional and similarly thoughtful amendments to the Rule and to its companion, the New Issue Rule, are forthcoming.

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<sup>11</sup> See the Proposing Release at 55323 (“[C]ertain funds, owing to several mitigating factors including their size, lack of affiliation with the account directly receiving the allocation and layered (and often opaque) ownership structure, generally do not raise the concerns that the Rule is designed to address.”).

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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