

## CLIENT MEMORANDUM

# FINRA Eases Compliance for Fund of Funds Investors Under the “Anti-Spinning” Rule

January 31, 2014

## AUTHOR

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Effective February 3, 2014, the Financial Industry Regulatory Authority, Inc. (“FINRA”) will provide an alternative way to comply with one of its rules governing allocation of equity IPOs, or New Issue securities.<sup>1</sup>

## Background

FINRA Rule 5131(b) restricts FINRA member broker-dealers from allocating New Issues to any account in which executive officers or directors of a public company<sup>2</sup> or covered non-public company<sup>3</sup> having one or more

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<sup>1</sup> See FINRA Regulatory Notice 13-43 (Dec. 2013). The definition of “New Issue” in FINRA Rule 5131 is the same as FINRA Rule 5130, and includes most initial public offerings of equity securities.

<sup>2</sup> A “public company” is defined in Rule 5131 as 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.

<sup>3</sup> A “covered non-public company” is defined in Rule 5131 to mean 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 shareholder 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 two of the last three fiscal years.

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relationships<sup>4</sup> with the broker-dealer firm or a person materially supported by such executive officers or directors (“Covered Persons”), have a beneficial interest, unless an exemption applies.<sup>5</sup> The general intent of these provisions in Rule 5131 is to prohibit the practice (commonly known as “spinning”) of allocating New Issue securities to the executive officers and directors of current or potential investment banking clients in exchange for investment banking business.<sup>6</sup>

Therefore, before selling New Issues to an account, such as a private fund, FINRA Member broker-dealers will ask the account about the Covered Person status of the account’s beneficial owners. Private fund managers therefore ask the investors in their funds about their status as Covered Persons. In addition to Rule 5131, FINRA Rule 5130 also restricts a FINRA broker-dealer from selling New Issues to any account in which a “restricted person” has a beneficial interest, unless an exemption set out in the rule applies.<sup>7</sup>

Fund managers typically will ask investors as part of the subscription process whether they are Covered Persons under FINRA Rule 5131 and whether they fit within any of the categories of a restricted person under the other New Issue allocation rule, FINRA Rule 5130. A private fund, after obtaining an initial affirmative representation from its investors, is permitted thereafter to rely on annual negative consent letters.<sup>8</sup> However, where an investor itself is a fund, such as a fund of funds, it may be difficult to obtain, track and aggregate information about the various affiliations of the fund of funds’ investors.

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<sup>4</sup> The Rule 5131(b) prohibition applies to the following relationships: (A) a public company or covered non-public company that is currently an investment banking services client of the broker-dealer firm, or a firm that has received compensation for investment banking services from the public company or covered non-public company in the last 12 months; (B) the person responsible for making the allocation decision at the broker-dealer knows or has reason to know that the broker-dealer firm intends to provide, or expects to be retained to provide, investment banking services within the next three months; or (C) there is an express or implied condition that the executive officer or director, on behalf of the public company or covered non-public company, will retain the broker-dealer firm for the performance of future investment banking services.

<sup>5</sup> Rule 5131(b) (2) permits allocations of New Issue securities to an account in which the collective beneficial interests of Covered Persons associated with any particular public company or covered non-public company represent 25 percent or less of the value of the account. Private funds typically have procedures in place to confirm that 25 percent or less of their interests are beneficially owned by Covered Persons associated with a particular company (or if so owned, that no New Issue securities profits will be allocated to those Covered Persons).

<sup>6</sup> See Willkie Farr & Gallagher LLP Client Memorandum “[FINRA’s Anti-Spinning Rule’s Impact on Private Funds](#)” March 8, 2011.

<sup>7</sup> See FINRA Rule 5130(1). A “restricted person” for purposes of Rule 5130 includes: a broker-dealer and its officers, directors, general partner, associated persons and employees; certain direct and indirect owners of a broker-dealer; a “finder” or a fiduciary of the managing underwriter of the offering of securities being considered for purchase; any person with authority to buy or sell securities for a bank, thrift institution, insurance company, investment company, investment adviser or other collective investment account (e.g., a hedge fund, other private fund, or other collective investment vehicle); and in some cases an immediate family member of such persons. Rule 5130(i)(10).

<sup>8</sup> See FINRA [Regulatory Notice 10-60](#) (Nov. 2010).

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### **Alternative Representation**

The new provision allows an account, such as a private fund, to rely on written representations from an investor that is an “unaffiliated private fund,” such as a fund of funds, that does not require the fund of funds for purposes of determining status under Rule 5131 to look through to its beneficial owners, other than the control persons of the adviser to the unaffiliated private fund.

The modification to Rule 5131 provides that an “unaffiliated private fund” is a “private fund,” as defined in Section 202(a)(29) of the Investment Advisers Act of 1940,<sup>9</sup> 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. Form ADV provides that control is the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise.

To rely on this relief, the unaffiliated private fund investor must also: (1) be managed by an investment adviser, (2) have assets greater than \$50 million, (3) 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 (4) not have been formed for the specific purpose of investing in the account.

### **Practical Consequences**

This new provision will provide an alternative for private fund managers to comply with the investor diligence required to invest in New Issues. Instead of having to ask about the Covered Person status of all the beneficial owners of unaffiliated funds wishing to invest and which public or covered non-public companies such indirect beneficial owners are affiliated with, a private fund manager can just ask about the control persons of the adviser to the unaffiliated fund, and have the unaffiliated fund make the representations in the new provision and reconfirm annually. However, this relief is only for Rule 5131, and the unaffiliated investing fund would still need to provide information about the beneficial interest owned in it by restricted persons under Rule 5130.

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<sup>9</sup> The term “private fund” means an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act.

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If you have any questions concerning the matters described in this memorandum, please contact Martin R. Miller (212-728-8690, [mmiller@willkie.com](mailto:mmiller@willkie.com)) or the Willkie attorney with whom you regularly work.

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