

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-70312; File No. SR-FINRA-2013-037)

September 4, 2013

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)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on August 23, 2013, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend FINRA Rule 5131 (New Issue Allocations and Distributions) to provide a limited exception to allow members to rely on written representations from certain accounts to comply with Rule 5131(b).

The text of the proposed rule change is available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA and at the Commission’s Public Reference Room.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

FINRA Rule 5131 (New Issue Allocations and Distributions) (the "Rule") addresses abuses in the allocation and distribution of "new issues."<sup>3</sup> Rule 5131(b) prohibits the practice of spinning, which refers to an underwriter's allocation of new issue shares to executive officers and directors of a company as an inducement to award the underwriter with investment banking business, or as consideration for investment banking business previously awarded (the "spinning" provision).

Specifically, the spinning provision provides that no member or person associated with a member may allocate shares of a new issue to any account in which an executive

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<sup>3</sup> Rule 5131 provides that "new issue" shall have the same meaning as in Rule 5130(i)(9).

officer or director of a public company<sup>4</sup> or a covered non-public company,<sup>5</sup> or a person materially supported<sup>6</sup> by such executive officer or director, has a beneficial interest:<sup>7</sup>

- if the company is currently an investment banking services<sup>8</sup> 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

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<sup>4</sup> 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).

<sup>5</sup> 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).

<sup>6</sup> “Material support” means directly or indirectly providing more than 25% 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).

<sup>7</sup> The Rule provides that the term “beneficial interest” shall have the same meaning as in Rule 5130(i)(1).

<sup>8</sup> “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).

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

Rule 5131.02 (Annual Representation) provides that, for the purposes of the spinning provision, a member may rely on a written representation obtained within the prior 12 months from the beneficial owner(s) of an account, or a person authorized to represent the beneficial owner(s), 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 on whose behalf such executive officer or director serves. Therefore, to comply with the spinning provision, firms typically issue questionnaires to their customers to ascertain whether any of the persons covered by the spinning provision have a beneficial interest in the account.<sup>9</sup>

Rule 5131(b)(2) provides a de minimis exception for new issue allocations to any account in which the beneficial interests of executive officers and directors of a company subject to the rule, and persons materially supported by such executive officers and directors, do not exceed in the aggregate 25% of such account. FINRA 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

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<sup>9</sup> The spinning provision currently addresses operational burdens associated with some accounts with a large and diverse ownership base where the potential for spinning is minimal through a series of exemptions for purchasers such as mutual funds, insurance company general accounts and various employee benefit plans. See generally Rule 5130(c). Private funds, however, are not a category of purchasers for which a general exemption exists.

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 believes that certain 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. Moreover, where the potential profits from a new issue allocation are spread across a large and diverse investor base, it is unlikely that the proportional benefit to any particular indirect investor would be of an amount that would further spinning (i.e., indirect fund ownership can be an impractical and ineffective means to receive any benefit from spinning). Therefore, FINRA is proposing a limited exception to the spinning provision in the fund of funds context that includes a set of conditions designed to ensure that the important protections of the Rule continue to be preserved, while offering meaningful relief for members and investors in situations where spinning abuse is not likely.

Specifically, FINRA is proposing to provide that members may 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 indirect beneficial owners of a fund invested in the account, that such fund:

- is a “private fund” as defined in the Investment Advisers Act of 1940;<sup>11</sup>

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<sup>10</sup> For example, members have noted that broker-dealers normally do not know the identity of the beneficial owners of the fund of funds invested in the account.

<sup>11</sup> 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.

- is managed by an investment adviser;
- has assets greater than \$50 million;
- 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;
- does not have a beneficial owner that also is a control person of such fund's investment adviser;
- is "unaffiliated" with the account in that the private fund's investment adviser does not have a control person in common with the account's investment adviser;<sup>12</sup> and
- was not formed for the specific purpose of investing in the account.

FINRA believes that these conditions are reasonable to assure that a member's new issue allocation will not be in furtherance of spinning, while reducing the compliance burdens associated with the Rule. In addition, a member may rely upon a written representation by an account as to the availability of this proposed exception unless it believes, or has reason to believe, that such representation is inaccurate.

Members availing themselves of the new supplementary material must maintain a copy of all records and information relating to whether an account is eligible to receive an allocation of the new issue under the spinning provision in its files for at least three years following the member's allocation to that account.

FINRA discussed with FINRA committees, industry groups and member firms the logistical impracticalities, costs and other hurdles involved in attempting to track

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<sup>12</sup> 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.

beneficial ownership. The comments are described in detail in Item 5 (sic) below. The proposal takes those discussions into account.

FINRA has considered various alternatives to the current approach, including proposing an exception for all private funds meeting certain asset thresholds, providing an interpretation to the existing de minimis exception, or requiring alternative percentage caps for direct and indirect beneficial ownership in the account. In considering these and other alternatives, FINRA sought to balance preserving the protections the Rule was designed to provide with limiting the scope of the rule to situations that might reasonably result in the harms sought to be addressed. FINRA also sought to avoid increasing complexity in the Rule, with added compliance costs, where the concerns to be avoided were remote.

As a result, FINRA determined that a wholesale exception for private funds was not appropriate.<sup>13</sup> In addition, because a fund indirectly invested in the account could consist of a single investor – potentially including covered persons – FINRA believes that a limit to both direct and indirect beneficial ownership is important in preserving the efficacy of the spinning provision. The proposed rule change is intended to balance the compliance concerns and burdens noted by the industry with FINRA’s goal of assuring that the Rule continues to be designed to promote investor confidence and prevent fraudulent and manipulative behaviors.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 120 days following Commission approval.

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<sup>13</sup> See supra note 9.

## 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>14</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed exception and required conditions will further these purposes by promoting capital formation and aiding member compliance efforts, while maintaining investor confidence in the capital markets.

Specifically, the proposed condition that the fund be managed by an investment adviser that is unaffiliated with the account's investment adviser seeks to ensure the structural independence of the funds' respective advisers. This requirement, in addition to the proviso that the unaffiliated private fund must not have been formed for the specific purpose of investing in the account, seeks to mitigate the possibility of collusive conduct aimed at furthering spinning.

In addition, the condition providing that the unaffiliated private fund may not have any beneficial owners who also are control persons of such fund's investment adviser seeks to eliminate the conflict that may exist where an adviser also is an investor in the fund and, therefore, may directly benefit from allocation decisions. The requirements regarding the minimum size of the private fund (over \$50 million) and the percentage ownership thresholds (private fund must own less than 25% of the account and not be a fund in which a single investor has a beneficial interest of 25% or more)

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<sup>14</sup> 15 U.S.C. 78o-3(b)(6).



seek to ensure that the proportional benefit of any new issue allocation to a single indirect beneficial owner would be insufficient to further spinning.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act in that the proposed rule provides an exception to Rule 5131(b) for funds of funds that face special difficulties under the existing exemptions from the Rule, and thus the proposed exemption tries to reduce differential impacts of the Rule. FINRA also believes that it is reasonable to permit members to rely on written representations from the account regarding compliance with the conditions of the exception as a means of achieving compliance with the purposes of the Rule without imposing layered tracking and other requirements on members that could be costly and unduly hamper the accounts' access to new issue shares.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

FINRA received four letters regarding the issues addressed by the proposed rule change from three commenters,<sup>15</sup> and engaged in additional discussions with industry

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<sup>15</sup> See Letters from Gregory J. Robbins, Senior Managing Director and General Counsel, Mesirow Advanced Strategies, Inc., to Gary L. Goldsholle, Vice President and Associate General Counsel, Office of the General Counsel, FINRA, dated June 10, 2011 ("Mesirow"); Andrew Baker, Chief Executive Officer, Alternative Investment Management Association, to Richard G. Ketchum, Chairman and Chief Executive Officer, FINRA, dated August 3, 2011 ("AIMA"); Stuart J. Kaswell, Executive Vice President and Managing Director and General Counsel, Managed Funds Association, to Marc Menchel, Executive Vice President and General Counsel, FINRA, dated August 19, 2011 ("MFA #1"); and Stuart J. Kaswell, Executive Vice President and Managing Director and General Counsel, Managed Funds Association, to Marc Menchel, Executive Vice President and General Counsel, FINRA, dated October 4, 2011 ("MFA #2").

groups and market participants regarding the operation of the spinning provision, the operation of the existing de minimis exception and members' difficulty in identifying indirect beneficial owners of an account. A list of the commenters is attached as Exhibit 2a. Copies of the comment letters received are attached as Exhibit 2b.

Commenters sought either interpretive guidance regarding the existing de minimis exception to increase its scope or a new amendment to address difficulties in allocating to investment funds, particularly in the fund of funds context. Commenters argued that investment funds are not an effective tool for a broker-dealer to convey a meaningful benefit to a particular covered person.<sup>16</sup> One commenter stated that the funds of funds it offers have investments in anywhere from 25 to 70 unaffiliated portfolio funds.<sup>17</sup> The commenter further noted that investors in a fund of funds, including any potential covered persons, cannot direct which broker a portfolio fund uses or will use, and may not know in which portfolio funds the fund of funds is invested.<sup>18</sup>

Commenters also discussed the logistical impracticalities and other hurdles involved in attempting to track beneficial ownership.<sup>19</sup> A commenter stated that, as currently structured, the spinning provisions potentially would require significant amounts of time and money to implement.<sup>20</sup> In addition, another commenter generally stated that funds of funds may (and often do) have several hundred investors, each of

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<sup>16</sup> See AIMA, Mesirow, MFA #1 and MFA #2.

<sup>17</sup> See Mesirow.

<sup>18</sup> See Mesirow.

<sup>19</sup> See e.g., AIMA, MFA #1 and MFA #2.

<sup>20</sup> See AIMA.

which themselves may have hundreds of beneficial owners; thus, the operational hurdles and cost of obtaining the relevant representations from all of the ultimate beneficial owners would be substantial.<sup>21</sup> The commenter further stated that obtaining beneficial ownership information is not always possible due to confidentiality and investor privacy concerns.<sup>22</sup>

FINRA has carefully considered the comments received and has considered the various alternatives suggested in crafting the current proposal and believes that the proposed rule change strikes the appropriate balance by simplifying the operation of the Rule while maintaining the protections the spinning provision is designed to provide, as discussed above.<sup>23</sup>

### III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

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<sup>21</sup> See MFA #2.

<sup>22</sup> See MFA #1.

<sup>23</sup> One commenter suggested, among other things, that the existing 25% de minimis exception be interpreted to apply separately to each public company or covered non-public company. However, the rule clearly states that the calculation is to be applied in the aggregate for all covered companies and the proposal would not change that requirement. See AIMA.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2013-037 on the subject line.

##### Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2013-037. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street,

NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2013-037 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>24</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>24</sup> 17 CFR 200.30-3(a)(12).