

Hedge Fund Report – Summary of Rules Affecting Investments in Initial Public Offerings

BY THE INVESTMENT MANAGEMENT PRACTICE

With a wave of initial public offerings (“IPOs”) expected in the next few months, hedge fund managers should be aware of FINRA’s rules with regard to investing in new issues. Fund managers who intend to invest in IPOs will need to comply with the certification requirements under Rules 5130 and 5131 by making annual representations about their eligibility to acquire new issues. Fund managers will likely need to obtain additional information from their investors in order to satisfy FINRA’s eligibility requirements. We describe each rule in more detail below, as well as the measures that fund managers should consider implementing to meet these requirements.

FINRA’s “New Issue” Rule

Rule 5130 establishes certain restrictions with respect to the purchase and sale of new issues (i.e., an IPO of an equity security as defined in Section 3(a)(11) of the Securities Exchange Act of 1934 made pursuant to a registration statement or offering circular).¹ The rule prohibits FINRA members from selling new issues to any account in which “restricted persons” have a beneficial interest. The term “restricted person” includes most associated persons of a member, most owners and affiliates of broker-dealers, and certain other classes of persons.²

The rule includes numerous exemptions,³ including one that permits restricted persons to hold interests in a collective investment account or pooled investment vehicle, so long as such holdings comprise no more than 10 percent of the beneficial ownership of the collective investment account or pooled investment vehicle.⁴

A FINRA member must meet certain preconditions before selling a new issue to any customer account. The member must have obtained a representation from its customer within the past 12 months that the customer is not a restricted person under the rule, and that restricted persons do not have more than 10 percent ownership in the customer.

Requirements for Hedge Funds. In order to comply with FINRA requirements, broker-dealers will ask private investment funds, including hedge funds, to make a representation regarding their eligibility to acquire IPO securities. Hedge fund managers should reconfirm that the aggregate beneficial ownership of restricted persons among their investors has not changed since the certifications made in the subscription documents and that this aggregate does not exceed the 10 percent threshold. FINRA members must receive these investor representations annually. The initial representation by a fund manager to a FINRA member must be an affirmative representation, but thereafter may be updated annually using negative consent letters.

The full text of Rule 5130 is available here:

http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11709&element_id=4894&highlight=5130#r11709.

FINRA's Prohibition on "Spinning"

New FINRA Rule 5131 supplements Rule 5130 by imposing additional restrictions on the allocation, pricing and distribution of new issues. The anti-spinning provisions will create new certification requirements when they go into effect on September 26, 2011.

The rule prohibits allocations of new issues to executive officers and directors of current, and certain former and prospective, investment banking clients. The spinning prohibition requires that FINRA members establish, maintain and enforce policies and procedures reasonably designed to ensure that investment banking personnel have no involvement or influence in decisions concerning new issue allocations.

Specifically, the rule prohibits FINRA members from allocating new issues to any account in which a beneficial interest in excess of 25 percent is held by (i) an executive officer or director of a public company or a covered non-public company,⁵ or (ii) a person materially supported⁶ by such executive officer or director ("Covered Persons"), if:

- the company is currently an investment banking client of the FINRA member;
- the member received compensation from the company for investment banking services in the past 12 months;
- the person making the allocation decision knows or has reason to know that the member expects to provide or to be retained for investment services within the next three months; or
- the allocation is made on the condition that such executive officer or director, on behalf of the company, retain the member for future investment banking services.

The anti-spinning provision exempts allocations of new issues to certain types of accounts, which are generally consistent with the types of accounts exempted by Rule 5130.⁷ The main area of divergence between the exemptions relates to accounts in which multiple persons have a beneficial interest. Rule 5131 permits allocations of new issues to an account, including a collective investment vehicle such as a hedge fund, in which the beneficial interests of Covered Persons do not exceed 25 percent in the aggregate. In contrast, the analogous exemption in Rule 5130 applies to accounts in which the collective beneficial interests of restricted persons do not exceed 10 percent.

The rule permits FINRA members to rely on written representations obtained in the past 12 months from the beneficial owner(s) of an account as to whether the beneficial owner is a Covered Person and if so, the company or companies with respect to which the Covered Person has that status. The initial representation must be an affirmative representation, but thereafter may be updated annually using negative consent letters.

Requirements for Hedge Funds. A hedge fund will not be permitted to receive new issue allocations if the aggregate beneficial interest of Covered Persons in the fund exceeds 25 percent. As with the new issue rule, broker-dealers will require hedge funds to make representations regarding their eligibility

to acquire IPO securities. Fund managers may need to obtain additional information from their investors to satisfy the new eligibility requirements. Fund managers should take steps to ascertain whether their investors are Covered Persons, including (i) obtaining written representations from existing investors and (ii) updating subscription documents to include these certifications for new investors.

The full text of Rule 5131 is available here:

http://finra.complinet.com/en/display/display_main.html?rbid=2403&record_id=13920.



If you have any questions concerning these developing issues, or if you require assistance in revising your fund documents, please do not hesitate to contact any of the following Paul Hastings lawyers:

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¹ New issues do not include offerings of debt securities or secondary offerings of equity securities.

² "Restricted persons" include FINRA members and other broker-dealers, broker-dealer personnel, finders and fiduciaries, portfolio managers, owners of broker-dealers, and certain immediate family members of these persons. Principals and employees of fund managers are generally restricted persons.

³ The Rule permits allocations of new issue securities, subject to certain conditions, to U.S.-registered investment companies, bank common trust fund accounts, insurance company accounts, accounts in which the aggregate beneficial interests of restricted persons do not exceed 10 percent, certain publicly traded entities listed or eligible to be listed on a U.S. exchange, non-U.S. investment companies, ERISA plans, state or municipal benefit plans, 501(c)(3) organizations and 414(e) church plans.

⁴ A common way to ensure that this requirement is met for funds in which restricted persons own in the aggregate more than a 10% beneficial interest is to allocate no more than 10% of any new issue to the fund accounts of such restricted persons.

⁵ 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 last fiscal year or in two of the last three fiscal years.

⁶ "Material support" means directly or indirectly providing more than 25 percent of a person's income in the prior calendar year. FINRA deems persons living in the same household as providing each other with material support.

⁷ See Endnote 2 above.

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