JACKO LAW GROUP, PC
SECURITIES & CORPORATE COUNSEL

Legal Risk Management Tip
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FINRA RULE 5131 – HOW IT IMPACTS BROKER-DEALERS AND PRIVATE FUNDS

FINRA Rule 5131 went into effect on May 27, 2011 to specifically prohibit certain abuses in the allocation and distribution of new issues. A "new issue" is any initial public offering ("IPO") of an equity security that is made pursuant to a registration statement or offering circular.[1] In FINRA's own words, Rule 5131 is "intended to sustain public confidence in the [IPO] process by establishing specific and detailed regulatory requirements with respect to the allocation, pricing and trading of new issues."[2] To that end, Rule 5131 limits broker-dealer practices for allocating new issues and details specific obligations for, among other things, *quid pro quo* allocations and prohibits certain practices regarding spinning and flipping of new issues. This Legal Risk Management Tip will discuss the details of the newly effective Rule and how broker-dealers and private funds may be affected by it.

1. ***Quid Pro Quo* Allocations**

Under the Rule, new issue allocations cannot be offered or threatened to be withheld in order to induce payment of compensation that is excessive in relation to the services provided. Rule 5131 therefore prohibits a member firm from allocating new issues in order to obtain a "kick back" in the form of excessive compensation for other services offered by the member.[3]

Rule 5131 also prohibits *quid pro quo* activity, not only with respect to trading services, but for all other services offered by the FINRA member. FINRA has stated, however, that this provision "is not intended to prohibit a member from allocating new issue shares to a customer because the customer has separately retained the member for other services, when the customer has not paid excessive compensation in relation to those services."[4] The determination as to whether the compensation is excessive will be based upon all relevant surrounding facts and circumstances, including, the level of risk and effort involved in the transaction and the rates generally charged for the same or similar services.[5]

2. **Prohibition on Spinning**

Spinning occurs when IPO shares are allocated to directors or executives of current or prospective investment banking clients in exchange for investment banking business.[6] Rule 5131's spinning prohibition provides that no member, or the member's associated persons, may

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[1] The definition of "new issue" also contains several exceptions. *See* FINRA Rule 5130(i)(9)(A)-(J).
[2] FINRA Regulatory Notice 10-60, November 29, 2010, *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122490.pdf.
[3] *Id.*
[4] *Id.* at Footnote 4.
[5] *Id.*
[6] *Id.*

allocate shares of a new issue to any account in which an executive officer or director of a public company has a beneficial interest 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;
- 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
- There is an 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.[7]

To facilitate compliance with the spinning prohibition, FINRA 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 is an executive officer or director and if so, the company or companies on whose behalf such executive officer or director serves. The Rule requires that the initial representation must be an affirmative representation, but subsequently may be updated annually through the use of negative consent letters.[8]

In order to help comply with Rule 5131's prohibition on spinning, the Rule requires that broker-dealers establish, maintain and enforce policies and procedures reasonably designed to ensure that investment banking personnel have no involvement or influence, directly or indirectly, in the new issue allocation decisions of the member.

3. Flipping

FINRA uses the term "flipping" to refer to the practice of selling new issues into the secondary market at a profit within 30 days following the offering date.[9] These sales generally create downward pressure on the secondary market trading price of the new issue, and underwriters and selling group members, therefore, seek to discourage such sales. Under most syndicate selling agreements, a managing underwriter is permitted to impose a "penalty bid" on syndicate members to reclaim the selling commissions or concessions for new issues that were subsequently flipped.

Independent of any syndicate penalty bid, some firms also have sought to recoup selling concessions from particular brokers when their customers flip a new issue. FINRA believes that the incentives created by linking a broker's ability to retain a commission to whether or not a customer holds onto the new issue has the potential of favoring institutional investors at the expense of retail customers.

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[7] FINRA Rule 5131(b).
[8] FINRA Rule 5131, Supplementary Material .02.
[9] FINRA Regulatory Notice 10-60, November 29, 2010, *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122490.pdf.

Accordingly, Rule 5131 prohibits any member or person associated with a member from directly or indirectly recouping, or attempting to recoup, any portion of a commission or credit paid or awarded to an associated person for selling shares of a new issue that are subsequently flipped by a customer, unless the managing underwriter has assessed a penalty bid on the entire syndicate.[10] FINRA believes that it is only appropriate for a firm to recoup a particular broker's compensation for selling a new issue in connection with a customer's decision to flip a security when the firm itself is required to forfeit its compensation to the managing underwriter.

4. Rule 5131's Impact on Private Funds

In order to help avoid running afoul of Rule 5131's prohibition on spinning, broker-dealers are permitted to rely on written representations obtained within the prior 12 months from the beneficial owner of an account as to whether such beneficial owner is an executive officer or director of a company covered by Rule 5131's spinning prohibition. A hedge or other private fund's brokerage account is not exempt from the Rule's prohibition on spinning, and the brokerage account will, therefore, be restricted from receiving new issue allocations if the collective beneficial interest exceeds 25%.

Many broker-dealers are sending questionnaires to hedge and other private fund managers in determining whether the fund's investors are executive officers or directors of an entity that provides investment banking services, and if so, whether these individual's beneficial interest exceeds 25%. Going forward, hedge fund managers who desire to be allocated new issues may wish to add questions to their subscription agreements to help them determine whether prospective investors will impact the fund's ability to remain compliant with Rule 5131's prohibition on spinning.

For more information about this topic and other legal services, please contact us at (619) 298-2880, info@jackolg.com or visit www.jackolg.com. Thank you.

Authors: Authors: Brent M. Cunningham, Esq. and Tyler Pearson; Editor: Michelle L. Jacko, Esq., Managing Partner, JLG. JLG works extensively with investment advisers, broker-dealers, investment companies, hedge funds, private equity firms and banks on legal and regulatory compliance matters.

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[10] FINRA Rule 5131(c).