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SECURITIES AND EXCHANGE COMMISSION
[Release No. 34-70957; File No. SR-FINRA-2013-037]

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

I. Introduction

On August 23, 2013, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change 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 proposed rule change was published for comment in the Federal Register on September 10, 2013.[3] The Commission received two comment letters in response to the proposed rule change.[4] On November 22, 2013, FINRA filed Amendment No. 1 with the Commission to respond to the comment letters and to propose a clarifying modification to the proposed exception regarding the eligibility of an unaffiliated private fund where a control

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 70312 (Sept. 4, 2013), 78 FR 55322 (Sept. 10, 2013) (Notice of Filing of SR-FINRA- 2013-037) ("Original Proposal"). The comment period ended on October 1, 2013.

4 See letter to Elizabeth M. Murphy, Secretary, Commission, from William G. Mulligan, CEO, Cordium US., dated Oct. 1, 2013 ("Cordium letter"); and letter to Elizabeth M. Murphy, Secretary, Commission, from Stuart J. Kaswell, Executive Vice President & Managing Director, Managed Funds Association, dated Sept. 30, 2013 ("MFA letter"). The letters are available on the Commission's website at http://www.sec.gov/comments/sr-finra-2013-037/finra2013037.shtml.

person of the fund's investment adviser also is a beneficial owner in the fund. The Commission is publishing this notice and order to solicit comments on Amendment No. 1 and to approve the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

II. Description of Proposal

On August 23, 2013, FINRA filed the Original Proposal to amend FINRA Rule 5131 to provide a limited exception to allow members to rely on written representations from certain accounts in complying with FINRA Rule 5131(b) (the "spinning provision").[5]

FINRA Rule 5131 addresses abuses in the allocation and distribution of "new issues,"[6] and paragraph (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 generally provides that no member or person associated with a member may allocate shares of a new issue to any account in which an executive officer or director of a public company[7] or a covered non-public company,[8] or a person materially

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5 See supra note 3.

6 The term "new issue" has the same meaning as in Rule 5130(i)(9). See Rule 5130(i)(9).

7 A "public company" is any company that is registered under Section 12 of the Act or files periodic reports pursuant to Section 15(d) thereof. See Rule 5131(e)(1).

8 The term "covered non-public company" means 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).

supported[9] by such executive officer or director, has a beneficial interest[10] if such public company or covered non-public company has certain current, recent or anticipated investment banking relationships with the member.

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 has a beneficial interest in the account.

Under the spinning provision, whether an account in which an executive officer or director of a company (or person materially supported by such executive officer or director) has a beneficial interest will be eligible to purchase shares of a new issue will depend upon whether the company is a current, recent or prospective investment banking client of the firm, as set forth in the rule. Where an executive officer or director of a company (or a person materially supported by such executive officer or director) has a beneficial interest in an account, a member must also be able to identify the company on whose behalf such executive officer or director serves to determine whether the company is a current, recent or prospective investment banking

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9 "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).

10 The term "beneficial interest" has the same meaning as in Rule 5130(i)(1). See Rule 5130(i)(1).

client of the firm under the rule; if the member is unable to obtain such information, it has to resort to restricting all new issue allocations to such account, which is not the intended purpose of the rule.

The spinning provision went into effect on September 26, 2011. and, since then, FINRA has received feedback from industry participants that obtaining the information necessary to ensure compliance with the rule, and eligibility for the de minimis exception, has proved difficult.[11] In particular, 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 ("FOF"), 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.[12]

Thus, in the Original Proposal, FINRA proposed a limited exception from the spinning provision, subject to a set of conditions, designed to ensure the important protections of Rule 5131(b) continue to be preserved, while offering meaningful relief for members and investors in situations where spinning abuse is not likely. Specifically, the Original Proposal provided 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 beneficial owners of a fund invested in the account, provided that such fund:

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11 Among other exceptions, 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.

12 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.

- is a "private fund" as defined in the Investment Advisers Act of 1940;
- 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;
- 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; and
- was not formed for the specific purpose of investing in the account.

The Original Proposal also required that, to be eligible for the exception, the unaffiliated private fund may not have a beneficial owner that also is a control person of such fund's investment adviser.

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.

III. Summary of Comments, FINRA's Response and Amendment No. 1

As stated above, the Commission received two comment letters in response to the Original Proposal.[13] Both commenters strongly support the adoption of the proposed amendment and stated that the proposed rule would ease the tracking burden for allocations to accounts that do not raise the concerns the spinning rule is designed to address, while also preserving the efficacy of the rule.[14] However, the commenters also suggest certain modifications that they

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13 See supra note 4.

14 See Cordium letter and MFA letter.

believe improve the usefulness of the proposed exception without compromising the objectives of the rule.[15]

Both commenters asked that FINRA eliminate the proposed condition that the unaffiliated private fund must not have a beneficial owner that also is a control person of such fund's investment adviser.[16] The commenters noted that it is not uncommon for an FOF to have an investor that is both a beneficial owner of the FOF and a control person of such fund's investment adviser.[17] One commenter noted that investment in the fund by a control person serves the purpose of aligning the interests of a control person with the interests of the fund's investors and, therefore, is a practice that institutional investors often require from fund managers.[18] The other commenter stated that this condition does not further the purposes of the spinning rule and recommended eliminating this aspect of the proposal.[19]

As an alternative, one commenter recommended that, rather than excluding funds with a beneficial owner that also is a control person of the investment adviser, the proposal instead should be amended to provide that a member 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 beneficial owners of a fund invested in the account (other than a beneficial owner that is a control person of the investment adviser to such private fund), subject to the other

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15 Id.

16 Id.

17 Id.

18 See MFA letter.

19 See Cordium letter.

proposed conditions.[20] FINRA agrees with this comment and, therefore, proposed a clarifying amendment to delete the proposed condition that the unaffiliated private fund must not have a beneficial owner that also is a control person of such fund's investment adviser and, instead, to include language substantially similar to that suggested by the commenter.[21]

Therefore, where a beneficial owner also is a control person of the FOF's adviser, a member must ascertain whether such person is a covered person based upon the standards set forth in Rule 5131(b). If a member obtains a written representation from an account that a beneficial owner in an unaffiliated private fund is a control person of such fund's investment adviser, but is not a covered person under the spinning provision, an allocation to such account would still be eligible for the proposed exception, if the conditions, as amended, are met. If a beneficial owner in an unaffiliated private fund is both a control person and a covered person under the spinning provision, a new issue allocation to such covered persons would be impermissible, unless such allocation is permitted under another exception (e.g., the de minimis exception).[22]

As stated above, the commenters noted that it is not uncommon for an FOF to have an investor that is both a beneficial owner of the FOF and a control person of such fund's investment adviser. Therefore, the Original Proposal would not have provided the intended relief for members in many cases where the efficacy of the spinning provision would still be preserved. Thus, instead of eliminating eligibility for the exception for any FOF with a beneficial owner that also is a control person of such fund's investment adviser, the revised

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20 See MFA letter.

21 See MFA letter.

22 See supra note 11.

proposal would permit a member to avail itself of the exception with respect to other beneficial owners (that are not also control persons of the FOF's investment adviser). FINRA believes that this revision to the proposal strikes the proper balance between members' concerns regarding the difficulty of identifying indirect beneficial owners of an account and preserving the important protections of Rule 5131(b).

One commenter also recommended that FINRA either reduce or eliminate the proposal's condition that, to be eligible under the exception, the unaffiliated private fund must have assets greater than $50 million.[23] This commenter believes that the percentage ownership threshold conditions, which require that the unaffiliated private fund own less than 25% of the account and does not have a single investor with a beneficial interest of 25% or more, along with the other conditions, are sufficient to ensure that spinning would be unlikely.[24]

FINRA is of the view that the percentage ownership threshold conditions alone are not sufficient to ensure that the protections of the spinning rule are preserved and, therefore, continues to believe that the "assets greater than $50 million" component is an appropriate additional safeguard. Specifically, FINRA believes that this requirement helps ensure a sufficient degree of dilution that would reduce the economic meaningfulness to a potentially covered person of any single IPO allocation, and therefore, does not propose eliminating or reducing this condition at this time.

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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23 See Cordium letter.

24 See Cordium letter.

IV. Commission Findings

After carefully considering the proposed rule change, as modified by Amendment No. 1, the comments submitted, and FINRA's responses to the comments, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.[25] In particular, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with Section 15A(b)(6) of the Act,[26] which requires, among other things, that FINRA rules 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.

Specifically, the Commission believes that the proposed exception and required conditions, as amended, are consistent with the provisions of the Act noted above by promoting capital formation and aiding member compliance efforts, while maintaining investor confidence in the capital markets. In simplifying and clarifying the operation of the proposed exception for FINRA members and other industry participants, the Commission believes that the proposed rule change, as modified by Amendment No. 1, reasonably balances the compliance concerns and the burdens noted by the industry while preserving the efficacy of the spinning provision and FINRA's goal of assuring that the rule continues to be designed to promote capital formation and investor confidence and prevent fraudulent and manipulative behaviors.

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[25] In approving this proposed rule change, the Commission has considered the proposed rule change's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

[26] 15 U.S.C. 78o-3(b)(6).

In addition, the Commission does not believe that the proposed rule change, as modified by Amendment No. 1, 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 change provides an exception to Rule 5131(b) for accounts with unaffiliated private fund investors that face special difficulties under the existing exceptions from the rule, and thus reduces differential impacts of the rule without compromising the objectives of the spinning provision.

The Commission believes that FINRA adequately addressed the comments raised in response to FINRA's notice.

V. Accelerated Approval

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,[27] for approving the proposed rule change, as modified by Amendment No. 1 thereto, prior to the 30th day after publication of Amendment No. 1 in the Federal Register. The changes proposed in Amendment No. 1 respond to the comment letters received by the Commission in response to the Original Proposal and further simplify the operation of the spinning provision for members and other industry participants.[28] In addition, accelerating approval of this proposed rule change, as modified by Amendment No. 1, should benefit FINRA members by aiding member compliance efforts while preserving the efficacy of the spinning provision and should benefit investors by maintaining investor protection in the capital markets.

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27 15 U.S.C. 78s(b)(2).

28 See MFA letter. See also Cordium letter.

VI. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as modified by Amendment No. 1, 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://sec.gov/rules/sro.shtml); or
- Send an e-mail to 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 person 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 21 DAYS FORM DATE OF PUBLICATION IN THE FEDERAL REGISTER].

VII. Conclusion

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act,[29] that the proposed rule change (SR-FINRA-2013-037), as modified by Amendment No. 1, be and hereby is approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[30]

Kevin M. O'Neill,
Deputy Secretary.

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[29] 15 U.S.C. 78s(b)(2).

[30] 17 CFR 200.30-3(a)(12).