August 19, 2011

Marc Menchel  
Executive Vice President and General Counsel for Regulation  
Financial Industry Regulatory Authority  
1735 K Street, NW  
Washington DC, 20006

Re: FINRA Rule 5131, New Issue Allocations and Distributions

Dear Mr. Menchel:

Managed Funds Association (“MFA”) appreciates the opportunity to provide comments in response to FINRA Rule 5131, New Issue Allocations and Distributions, which is designed to prohibit inappropriate activity related to the allocation and distribution of new issues, including “spinning” and quid pro quo arrangements.

MFA strongly agrees with the objective of Rule 5131 to promote public confidence in the initial public offering process by preventing conflicts of interest or impropriety by employees of public and non-public companies in connection with the allocation of new issues. MFA members are active investors and significant stakeholders in such companies, and depend on fair and open markets to conduct their investing activity, and honest and ethical management to act in all investors’ best interests. Accordingly, we share FINRA’s goals to ensure that the IPO process is conducted fairly and without any undue influence, and that corporate management makes decisions for the benefit of shareholders.

Initial public offerings are a critical source of funding for private companies to expand their businesses, and as participants in the IPO market, hedge funds and other investors play an important role in allocating capital to these companies. In light of this activity, many hedge fund managers have assessed the effect of the anti-spinning provision in Rule 5131 on their participation in new issue allocations, and in particular the scope of the de minimis exemption, upon which many

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1 MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

managers will seek to rely. As described below, we are concerned that the provision could reduce hedge funds’ willingness to invest in IPOs in a manner that we do not believe FINRA intended. We are hopeful that interpretive guidance clarifying the exemption would largely address these concerns.

Application of Anti-Spinning Provision to Hedge Funds

We appreciate the policy basis for the anti-spinning prohibition, and support the goal of preventing inappropriate activity by covered employees of public and non-public companies in connection with the IPO process. We also agree that the Rule should be designed to prevent individuals from seeking to avoid the restrictions by obtaining new issue allocations indirectly, such as through an ownership interest in a pooled investment vehicle.

Nevertheless, the structure and investment activity of most hedge funds make it unlikely that an individual could seek to use an investment in a fund to engage in a spinning arrangement. Hedge funds are managed by an investment adviser that is responsible for investment decisions, including the selection of brokers and determinations to participate in an initial public offering. Fund investors are generally not affiliated with the manager, do not influence or have control over the manager, are not involved in choosing fund investments, and typically have only limited transparency as to the fund’s activities and investment positions, for example by receiving periodic summary information on a delayed basis from the manager. In the case of hedge funds with investors that themselves are pooled investment vehicles (e.g., funds of hedge funds), the underlying beneficial owners of such investors are even further removed from the fund manager than direct investors, and have even more limited knowledge of a fund’s activities, since they do not receive information directly from the manager. This structure would preclude a hedge fund investor from evading the anti-spinning provision absent the consent and participation of the manager.

In addition, hedge funds typically have a diversified range of investors and allocate their capital across a broad portfolio of assets, so that any profit or loss allocation from a single investment, including a new issue, would have only a small effect on the overall returns of each investor. Investments in hedge funds are also generally subject to restrictive liquidity terms, with redemptions typically permitted only on a quarterly basis, and in many cases are subject to other restrictions, such as a minimum one-year investment period. As a result of these features, an investor typically would only have an indirect, diluted financial interest in any specific new issue allocation, and could not use a hedge fund investment to obtain exposure only to a single allocation.

Together, these factors significantly reduce the risk of spinning by a hedge fund investor through an investment in a hedge fund, and we encourage regulators to take them into consideration in determining how a hedge fund should comply with Rule 5131.

3 Rule 5131(b) prohibits FINRA members from allocating shares of a new issue to an account in which an executive officer or director of a public company, or a covered non-public company (“covered employees”), has a beneficial interest if the company is, or is expected to be, an investment banking client of the firm.

Paragraph (b)(2) exempts new issue allocations to, among others, an account in which the beneficial interests of executive officers and directors of the company in total do not exceed 25% of the account.

4 Typically, however, individuals affiliated with the investment manager, including its owners and officers, will also invest in the fund as a means of aligning their interests with fund investors.
We appreciate that the Rule provides exemptions from the anti-spinning provision for certain types of entities, as well as accounts where the ownership interest of covered employees, such as in a pooled investment vehicle, is small and does not give rise to the types of concerns underlying the provision. The list of exempted entities does not include hedge funds, and managers will therefore need to comply with the de minimis exemption to obtain new issue allocations. In its current form, however, the de minimis exemption has resulted in considerable confusion and uncertainty in the hedge fund industry. Indeed, in the short time since the rule became final, law firms have offered various divergent and inconsistent interpretations of the steps a manager would need to take to rely on the exemption. Some of these interpretations are likely to lead hedge fund managers to impose overly broad restrictions on allocating new issues to their funds to both comply with the exemption and receive new issue allocations.

An important concern is that, according to some analyses, to rely on the exemption a manager would need to regularly collect and calculate information about the business affiliations of not only a fund’s direct investors, but also the affiliations and ownership interests of individuals who invest through unaffiliated pooled vehicles (e.g., beneficial owners of a fund of hedge funds). However, for various legitimate reasons, including logistical burdens, investor privacy and confidentiality concerns, unaffiliated investment managers, banks, investment banks and other intermediaries that invest in hedge funds, generally do not share detailed information about their investors with managers of funds in which they invest. As a result, hedge fund managers generally do not have access to information about these types of indirect investors, and are often not in a position to gather or request data about them. The difficulty this creates for complying with the de minimis exemption by looking through to indirect investors is compounded by the fact that these indirect investors regularly purchase and redeem interests in the pooled vehicle investors, and may change their employment status, so that a hedge fund manager would need to calculate the number of covered employees on an ongoing basis. It generally is not possible for a manager to gather this information in the short time period between learning about a new issue and requesting an allocation, and even if a manager could gather such information, the structure of hedge funds would not generally permit a manager to allocate the applicable new issue solely to persons that are not covered employees with respect to such allocation.

For these reasons, managers will not be able to properly identify covered employees in pooled vehicle investors, and many intend either to prohibit pooled vehicle investors in a hedge fund from all new issue allocations if there are any restricted investors in the pooled vehicle, or only allocate new issues to a pooled vehicle investor if it will not allocate any new issue to a restricted investor, regardless of the covered company of the investor. In some cases, hedge fund managers may choose to not participate at all in a new issue allocation. If managers across the industry adopt these or similar approaches, hedge fund participation in initial public offerings is likely to decline, thereby decreasing investor demand for new issues and impairing an important source of capital to growing companies.

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5 The prohibitions in Rule 5131(b) do not apply to allocations of shares of a new issue to accounts described in Rule 5130(c)(1) through (3) and (5) through (10).

For these reasons, we recommend that FINRA provide additional guidance that would allow a pooled investment vehicle to rely on the *de minimis* exemption from the anti-spinning provision under the following conditions:

(i) The pooled investment vehicle meets the definition of “private fund” in Section 202(a)(29) of the Investment Advisers Act of 1940, as 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 Section 3(c)(7) of the Investment Company Act; and

(ii) Each direct investor in the pooled investment vehicle either:

   a. Can rely on an exemption under Rule 5131(b)(2), including the *de minimis* exemption, or  
   b. Owns interests less than or equal to 25% of the pooled investment vehicle, and  
      the manager of the pooled investment vehicle has no knowledge that the investor   
      was established to evade the anti-spinning prohibitions in Rule 5131(b).

This guidance would be consistent with the intent of the Rule, and help ensure that hedge funds and funds of hedge funds do not become vehicles for circumventing the Rule. At the same time, the guidance would enable these entities to participate in IPOs instead of concluding that such participation was impracticable.

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MFA appreciates the opportunity to provide these comments to FINRA in response to the Rule. If you have any questions about these comments, or if we can provide further information, please do not hesitate to contact Matthew Newell, Assistant General Counsel, or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & Managing Director,
General Counsel

Cc: Gary L. Goldsholle, Vice President and Associate General Counsel, FINRA