

Financial Industry Regulatory Authority (“FINRA”) Restrictions on New Issues

FINRA Rule 2790

FINRA Rule 2790 is intended to protect the integrity of the public offering system by placing significant limits on a broker-dealer’s ability to purchase or hold certain new issues or sell them to favored clients or certain other persons who may direct future business to the broker-dealer. Though most fund managers are not broker-dealers, Rule 2790 may directly or indirectly affect a fund manager’s or its employees’ investment activities.

Application of Rule 2790

Rule 2790 applies to all initial public offerings of equity securities, including foreign offerings. However, Rule 2790 does not apply to the following types of offerings:

- Secondary or “follow-on” offerings;
- Debt offerings (whether or not they are investment grade);
- Investment-grade asset-backed securities;
- Offerings pursuant to various exemptions under the Securities Act of 1933 if the securities are “restricted”;
- Offerings of government and municipal securities;
- Interests in a commodity pool;
- Rights offerings, exchange offers or offers pursuant to a merger or acquisition;
- Shares in registered investment companies, and;
- American Depositary Receipts (ADRs) registered on Form F-6 that have a pre-existing market outside the U.S.

Restricted Persons

Rule 2790 imposes a variety of restrictions on a broker-dealer (or person associated with it) from selling shares of a new issue to certain “restricted persons.” These complicated restrictions frequently impact the extent to which a fund manager seeks or is able to purchase new issues. “Restricted persons” generally include any person with authority to buy or sell securities for an investment company, investment adviser, or other collective investment account (e.g., a hedge fund or investment partnership), including hedge fund managers.

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Operation of Rule 2790

In applying these restrictions, Rule 2790 covers not only direct purchases by “restricted persons,” but also purchases by accounts or funds in which the individuals may have an interest. However, Rule 2790 excludes a number of funds from its coverage, including pension plans subject to ERISA that are qualified under Section 401(a) of the Internal Revenue Code of 1986, which may purchase new issues unless the sponsor of the pension plan is a broker-dealer company. In addition, state and governmental benefit plans and church plans under Section 414(e) of the IRC may purchase new issues.

Other Regulatory Issues

In addition to the FINRA Rules, the purchase of new issues by hedge funds and other private funds may raise other legal and regulatory issues. One notable concern is that these purchases be allocated fairly by the fund manager. Moreover, both the SEC and FINRA have closely scrutinized and sanctioned broker-dealers’ sales of new issues to particular investors -typically hedge funds- that explicitly or implicitly agree to compensate the broker-dealer with trades at inflated commission rates (or with trades in excessive quantities). Similarly, regulators would likely view an explicit or implicit agreement by a fund manager to purchase certain shares in the aftermarket (i.e., the trading market for the shares after a public offering ends) -known as “laddering” or “tie-ins”- as a form of market manipulation, since it would artificially inflate the aftermarket price of the stock.

This memorandum is intended to inform Malik Law Group’s clients of certain legal matters and is not intended as legal advice. You should consult a lawyer before taking any action based on the information contained above. Please contact Malik Law Group with any questions or comments you may have about this memorandum.

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