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FINRA Proposes to Broaden Exemptions to the New Issue and Spinning Rules

Amendments to Rules 5130 and 5131 Would Expand and Clarify Various Specific Exemptions and Align the Rules' Anti-Dilution Provisions

SUMMARY

On July 26, 2019, FINRA filed proposed rule changes with the SEC to amend Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) and Rule 5131 (New Issue Allocations and Distributions) to exempt additional persons from the scope of the rules, modify current exemptions to further regulatory consistency, address unintended operational impediments and exempt certain types of offerings from the rules' scope. The proposed changes would: (1) incorporate the definition of "family member" and "family client" under the Investment Advisers Act of 1940 (the "Advisers Act") into the definition of "family investment vehicle" under Rule 5130; (2) exclude sovereign entities that own broker-dealers from the categories of restricted persons under Rule 5130; (3) exempt foreign employee retirement benefits plans that meet specified conditions from the rules; (4) provide alternative conditions for satisfying the foreign investment company exemption under Rule 5130; (5) exclude offerings that are conducted pursuant to Regulation S from the definition of "new issue" under the rules; (6) harmonize the issuer-directed provisions of Rule 5130(d) with those of Rule 5131.01; (7) exclude unaffiliated charitable organizations from the definition of "covered non-public company" in Rule 5131; and (8) add an anti-dilution provision to Rule 5131 to align it with a similar provision in Rule 5130. The SEC has not yet published a notice soliciting comments on the proposed rule changes.

BACKGROUND

In April 2017, FINRA published *Regulatory Notice 17-14 (Capital Formation)* seeking comment from its members and other stakeholders on the effectiveness and efficiency of its rules, operations and administrative processes relating to broker-dealer activities involved in capital formation.[1] The new

proposal[2] (the "Proposal") is based on comments received from members and FINRA's own experience with the rules.

Rule 5130, known as the "new issue rule", applies to equity IPOs[3] and generally prohibits a member or an associated person of a member from allocating such new issues to any account in which certain "restricted persons" have a beneficial interest. The rule is designed to ensure fairness in the public offering process by: (1) requiring bona fide public offerings of securities at the offering price; (2) preventing the withholding of securities in a public offering for a member's own benefit or use of securities to reward persons who are in a position to direct future business to members; and (3) inhibiting industry insiders from taking advantage of their insider situation to purchase new issues for their own benefit at the expense of public customers. Its counterpart, Rule 5131(b), is FINRA's "spinning" rule and prohibits a member or an associated person of a member from allocating new issues to any account in which an executive officer or director of a U.S. public reporting company or "covered non-public company",[4] or a person "materially supported"[5] by such an executive officer or director, has a beneficial interest, and where the member has or intends to pursue certain investment banking relationships with the company.

FAMILY OFFICES

FINRA is proposing to expand the definition of "family investment vehicle" under Rule 5130 to include entities that are beneficially owned solely by "family members" and "family clients", terms that are used in the context of family offices and defined in Advisers Act Rule 202(a)(11)(G)-1. That rule defines a "family office" as a company that, among other conditions, is wholly owned by family clients, which includes, among other defined persons, "family members" and "key employees" of the family office. Rule 5130 addresses family offices by excluding the term "family investment vehicle", a legal entity that is beneficially owned solely by immediate family members,[6] from the category of collective investment accounts that could cause a person to be deemed a "restricted person" as a portfolio manager.[7]

Although the scope of permitted participants in the Advisers Act definition of "family office" and in Rule 5130's definition of "family investment vehicle" overlap in significant respects, there are definitional inconsistences.[8] FINRA is proposing to incorporate the definitions of "family member" and "family client" under the Advisers Act into the definition of "family investment vehicle" under Rule 5130, subject to some limitations. Specifically, the proposed rule change would define a "family investment vehicle" as a legal entity that is beneficially owned solely by one or more of the following three types of persons: (1) "immediate family members" as defined under Rule 5130(i)(5); (2) "family members" as defined under Advisers Act Rule 202(a)(11)(G)-1(d)(6); or (3) "family clients" as defined under Advisers Act Rule 202(a)(11)(G)-1(d)(4); provided, that where the beneficial owners of such an entity include family clients, the person who has the sole authority to buy or sell securities for the entity is an "immediate family member" as defined in Rule 5130(i)(5) or a "family member" as defined in Advisers Act Rule 202(a)(11)(G)-1(d)(6). FINRA is proposing this condition to ensure that, for purposes of Rule 5130, the person who has the authority to buy or sell securities for the account is more closely aligned with the family than with key employees or others associated with the family office.

SOVEREIGN ENTITIES

FINRA describes a sovereign wealth fund as a pool of capital or an investment fund that is owned or controlled by a sovereign nation and is created for the purpose of making investments on behalf of the sovereign nation. When a sovereign wealth fund or a sovereign nation (collectively, a "sovereign entity") acquires a direct or indirect ownership stake in a registered broker-dealer, the sovereign entity must be listed on Schedule A or B of Form BD. As a result, the sovereign entity is deemed a "restricted person", as that term is defined in subsection (i)(10)(E) of Rule 5130, unless the ownership interest is less than 10%.[9] FINRA is proposing to exclude sovereign entities from the definition, because the provision was intended to prevent broker-dealers from circumventing the rule's new issue purchase prohibition and in FINRA's view sovereign entities are unlikely to circumvent the prohibition by reallocating new issue shares to their broker-dealer subsidiaries. The proposed exclusion would not apply to affiliates of sovereign entities that are otherwise restricted under the rule.

FOREIGN EMPLOYEE RETIREMENT BENEFITS PLANS

Rule 5130(c)(7) exempts from the rule's prohibitions an ERISA benefits plan that is qualified under Section 401(a) of the Internal Revenue Code, provided that the plan is not sponsored solely by a broker-dealer. Employee retirement benefits plans that are organized under and governed by foreign laws do not qualify for this exemption. FINRA is proposing to extend the Rule 5130(c)(7) exemption to foreign employee retirement benefits plans, provided that the plan or family of plans: (1) has, in aggregate, at least 10,000 participants and beneficiaries and $10 billion in assets; (2) is operated in a non-discriminatory manner with respect to its inclusion of a wide range of employees, regardless of income or position; (3) is administered by trustees and managers that have a fiduciary obligation to administer the funds in the best interest of the participants and beneficiaries; and (4) is not sponsored by a broker-dealer. FINRA states that the rationale underlying Rule 5130(c)(7)'s ERISA exemption applies equally to foreign benefits plans when the four conditions are met. With the same rationale, FINRA is also proposing to add a corresponding exemption to Rule 5131(b)(2), because it believes the practice of spinning is unlikely to occur in connection with a covered person's beneficial interest in a foreign employee retirement benefits plan.

ALTERNATIVE CONDITIONS FOR FOREIGN INVESTMENT COMPANY EXEMPTION

Rule 5130(c)(6) exempts sales to and purchases by an investment company organized under the laws of a foreign jurisdiction, provided that: (1) the investment company is listed on a foreign exchange for sale to the public or authorized for sale to the public by a foreign regulatory authority; and (2) no person owning more than five percent of the shares of the investment company is a restricted person. The purpose of the five percent condition is to prevent purchases of new issues by foreign investment companies with concentrated ownership interests held by restricted persons. However, FINRA has concluded, based on its experience with the rule and informal feedback from market participants, that it is operationally impractical for a foreign investment company to determine whether an investor owns more than five percent of its shares where the investor acquires his or her interest through an intermediary (or multiple

intermediaries) that then holds the shares for multiple investors in an omnibus or nominee account. Due to these operational issues raised by the five percent condition, FINRA is proposing to amend Rule 5130(c)(6) to add two alternative ways to establish that a foreign investment company satisfies the concentration of ownership prong of the rule: (1) the investment company has 100 or more direct investors; or (2) the investment company has 1,000 or more indirect investors. FINRA is also adding an additional condition to Rule 5130(c)(6), that the foreign investment company not be formed for the specific purpose of investing in new issues.

EXCLUSION FOR FOREIGN OFFERINGS

Currently the definition of new issue for purposes of Rules 5130 and 5131 is not expressly limited to domestic securities offerings and could apply to foreign offerings, even if such offerings are afforded a safe harbor from registration under the Securities Act, to the extent a member or an associated person is participating in the offering or receiving allocations of new issues as an investor. FINRA is proposing to exclude Regulation S offerings from Rules 5130 and 5131, as well as other offerings made outside the United States or its territories, because some foreign jurisdictions may not restrict market participants, such as broker-dealers, from purchasing IPO shares for their own account and prohibiting members and associated persons from purchasing IPO shares in foreign offerings may indirectly impede the capital formation process in those foreign jurisdictions.

ISSUER-DIRECTED SECURITIES

Rules 5130(d) and 5131.01 contain exemptive provisions for new issue allocations that are directed by an issuer when specific conditions are met, because the regulatory concerns that the rules are designed to address are not present with allocations of securities that are not controlled by an underwriter. Currently, Rule 5131 exempts allocations directed by affiliates and selling shareholders, as well as by the issuer, while Rule 5130 exempts only those directed by the issuer. FINRA is proposing to conform Rule 5130(d) to the issuer-directed provision of Rule 5131.01, expanding the exemption for issuer-directed securities to allocations directed by affiliates and selling shareholders of the issuer and clarifying that the exemption applies only to shares that are specifically directed in writing.

EXCLUSION FOR UNAFFILIATED CHARITABLE ORGANIZATIONS

Rule 5131(b) 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 or a covered non-public company, or a person materially supported by such executive officer or director, has a beneficial interest: (1) if the company is currently a member's client for investment banking services or has compensated the member for investment banking services in the past 12 months; (2) if the person responsible for making the allocation decision knows or has reason to know that the member intends to provide, or be retained by, the company with investment banking services within the next three months; or (3) on the express or implied condition that such executive officer or director, on behalf of the company, will retain the member for future investment banking services. The rule is designed to safeguard against the allocation of new issues to

executive officers and directors who are in a position to hire members on behalf of the company they serve and where there is the potential to divide the loyalty of the executive officers and directors of the company. FINRA is proposing to exclude unaffiliated charitable organizations from the definition of covered non-public company so that an executive officer or director of a charitable organization that is not affiliated with the member allocating IPO shares would not be subject to the rule's spinning provision. While some charitable organizations, due to their asset size, fall within the definition of a covered non-public company, FINRA states that it considers it unlikely that these organizations would generate significant investment banking business, and so there is a low risk that the improper incentives would motivate a member's or an associated person's decision to allocate shares to their executive officers or directors.

ADDITION OF ANTI-DILUTION PROVISION TO RULE 5131

FINRA Rule 5130 allows restricted persons that are existing equity owners of an issuer to purchase shares of the issuer in a public offering in order to avoid dilution of their equity ownership. Rule 5131 does not currently include a similar anti-dilution provision. FINRA is proposing to amend Rule 5131 to add an anti-dilution provision that would allow an executive officer or director of a public or a covered non-public company (or a person materially supported by such a person) to retain their percentage equity ownership in the issuer at a level up to the ownership interest as of three months prior to the filing of the registration statement, provided that certain conditions are met.

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ENDNOTES

1 FINRA, *Regulatory Notice 17-14 (Capital Formation): FINRA Requests Comment on FINRA Rules Impacting Capital Formation* (April 2017), *available at* http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-14.pdf.

2 FINRA, *Proposed Rule Change to Amend FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) and FINRA Rule 5131 (New Issue Allocations and Distributions)*, SR-FINRA-2019-22 (July 26, 2019), *available at* https://www.finra.org/sites/default/files/rule_filing_file/SR-FINRA-2019-022.pdf.

3 "New issue" means any IPO of an equity security as defined in Section 3(a)(11) of the Securities Act, made pursuant to a registration statement or offering circular, subject to some exceptions. *See* Rules 5130(i)(9) and 5131(e)(7).

4 The term "covered non-public company" means any non-public company satisfying the following criteria: (1) 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; (2) shareholders' equity of at least $30 million and a two-year operating history; or (3) 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).

5 Rule 5131 defines "material support" to mean directly or indirectly providing more than 25 percent 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).

6 *See* Rule 5130(i)(4).

7 *See* Rule 5130(i)(10)(D) (Portfolio Managers).

8 Proposal at 9. For example, the definition of "immediate family member" under Rule 5130 includes a person's parents, mother-in-law or father-in-law, spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law and children, whereas the definition of "family member" under the Advisers Act includes lineal descendants of a common ancestor and the lineal descendants' spouses or spousal equivalents. *See* 17 C.F.R. § 275.202(a)(11)(G)-1(d)(6). As a result, the inclusion of grandchildren or grandparents in a collective investment account will not disqualify the account from the family office designation under the Advisers Act on that basis, but would cause such an account to fall outside of the definition of "family investment vehicle" under Rule 5130.

9 *See* Rule 5130(i)(10)(E).

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