Amendments to the FINRA New Issue Rule (Rule 5130) and Anti-Spinning Rule (Rule 5131): First Analysis

A Lexis Practice Advisor® Practice Note by
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Introduction

This article discusses recent amendments to Financial Industry Regulatory Authority (FINRA) Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) and Rule 5131 (New Issue Allocations and Distributions), which were originally published for comment in the Federal Register on August 8, 2019 and approved by the Securities and Exchange Commission (the SEC) on November 5, 2019. The amendments became effective on January 1, 2020, as discussed in the FINRA Regulatory Notice 19-37 published on December 19, 2019. The new rules broaden the categories of investors that are exempt from the rules' restrictions and narrow the types of securities offerings that are subject to the rules. The new rules will allow broker-dealers to sell new issues to new categories of investors.

For additional information on Rule 5130, Rule 5131 and other related FINRA rules, see FINRA Resource Kit.

Background

Rule 5130 generally prohibits, subject to certain exceptions, a FINRA member (or an associated person thereof) from selling new issue securities to, or purchasing new issue securities for, an account in which a "restricted person" (as defined in the rule) has a beneficial interest. Rule 5131 addresses abuses in the allocation and distribution of new issues and generally prohibits, subject to certain exceptions, the allocation of new issue securities by FINRA members to accounts in which an executive officer or director of a public company or covered non-public company has a beneficial interest, if such company is a current, former or prospective investment banking client of the FINRA member (a practice called "spinning"). These rules were originally adopted after the dotcom bust to protect the integrity of the public offering process by preventing financial services industry insiders from gaining access to new issues while potentially excluding public investors, and preventing "spinning" (as explained below), flipping and quid pro quo allocations of new issues, as well as other pricing and trading abuses in initial public offerings.

Since adoption of the rules, certain interpretation issues have arisen regarding the scope of persons to which offers and sales of new issues can be made, including family offices and their key employees, directors and executives of non-profit organizations and certain foreign entities. The amendments seek to clarify such issues.

Initial Guidance

Below is a summary of the principal changes.

- **U.S. and foreign employee retirement plans.** Rule 5130 contained exemptive relief on a case-by-case basis for certain U.S. and foreign employee retirement plans,

provided that the plan is not sponsored solely by a broker-dealer. Since employee retirement benefit plans invest in new offerings on behalf of potentially "hundreds of thousands" of beneficial owners, and determining whether any beneficial owner is a restricted person may be impossible, the amended rules add a general exemption for U.S. and foreign employee retirement plans that (1) have at least 10,000 participants and beneficiaries and $10 billion in assets; (2) operate in a non-discriminatory manner and permit employees regardless of income or position to participate; (3) are administered by trustees and managers that have a fiduciary obligation to administer the funds in the best interests of the participants and beneficiaries; and (4) are not sponsored by a broker-dealer.

- **Allocations by foreign investment companies.** Under Rule 5130, a non-FINRA member investment company organized under the laws of a foreign jurisdiction is exempt if (1) it is listed on a foreign exchange for sale to the public and (2) no person owning more than 5% of such entity is a restricted person. However, the 5% restricted person ownership limitation is impractical to administer in most cases, because foreign investment company shares are often purchased through nominee intermediaries and the foreign investment company is unable to determine the restricted person status of such owners. To address concerns related to the difficulty of ascertaining compliance with the 5% restricted person ownership limitation, the amended rules broaden that prong of the exemption to also include "widely held" foreign investment companies that have (1) 100 or more direct investors or (2) 1,000 or more indirect investors. In addition, under the amended rules, foreign investment companies must also not be formed for the specific purpose of permitting "restricted persons" to invest in new issues.
- **Sovereign entity exemption.** Sovereign wealth funds that acquire direct or indirect ownership in registered broker-dealers in excess of thresholds requiring them to be listed on the broker-dealer's Form BD were treated as restricted persons for purposes of Rule 5130. Under this criteria, certain sovereign entities, including sovereign wealth funds that have purchased direct or indirect interests in a U.S. broker-dealer as a result of a larger private equity transaction, have become restricted persons and were prevented from purchasing new issues. The amended rules modify the definition of restricted person to exclude "sovereign entities," which are defined to include pools of capital, investment funds and other entities owned or controlled by a sovereign nation and created for the purpose of making investments on behalf of, or for the benefit of, the sovereign nation, its political subdivisions, agencies or instrumentalities.
- **Exclusion for foreign offerings.** In order to remove any potential and unintended impediments to the public offering process in foreign jurisdictions, the amended rules exclude from the definition of "new issue" offshore offerings made pursuant to Regulation S as well as other offerings made outside of the United States, provided that the securities in the offering are not concurrently registered for sale in the United States. In addition, FINRA has adopted Rule 5130.01 and Rule 5131.05 to clarify that, even if a foreign offering is concurrently registered for sale in the United States, the rules do not prohibit allocations of new issues to non-U.S. persons by foreign non-member broker-dealers participating in the underwriting syndicate, provided that such allocation decisions are not made at the direction or request of a member firm or its associated persons.
- **Exclusion for offerings by SPACs.** Rule 5130 excludes offerings of securities by registered closed-end investment companies, business development companies, direct participation programs and real estate investment trusts from the definition of "new issue." The amended rule adds offerings by special purpose acquisition companies (SPACs) to the exclusion since, similar to the other entities included in the exclusion, offerings by SPACs typically commence trading at the public offering price with little potential for trading at a premium given that a SPAC's assets at the time its initial public offering trades consist of the capital it raised through the offering process. Moreover, if there is a premium, it is generally small.
- **Issuer-directed securities.** The amended rules expand and clarify the exemption from the prohibitions under the new issue rules for issuer-directed allocations of new issue securities, subject to certain specified conditions. Rule 5130(d) has been amended to clarify that issuer directions must be in writing (a provision already found in Rule 5131.01) and to apply the exemption to securities directed by affiliates and selling shareholders of the issuer. In addition, the amendment clarifies that the exemption also applies to securities that are directed by a single affiliate or a single selling shareholder of the issuer. Finally, FINRA amended Rule 5130(d)(1)(B) to permit issuer-directed allocations of securities to employees and directors of franchisees.
- **Charitable organizations.** Charitable organizations are specific types of non-profit organizations that FINRA believes "are not likely to generate significant investment banking business and, thus, there is a low risk, if any, that improper incentives would motivate a member's or an associated person's decision to allocate shares to the account of executive officers or directors of such organizations." Rule 5131(b) prohibits FINRA member

firms from allocating new issues to an account owned by an executive officer or director of a public or covered non-public company, because executive officers and directors of those companies have the ability to make the decision to hire investment bankers. Amended Rule 5131 excludes unaffiliated charitable organizations from the definition of "covered non-public company" on the basis that charitable organizations do not frequently engage in investment banking activities and therefore the risk of impropriety is low, and expressly excludes executive officers and directors of these types of non-profit organizations from being "covered persons" subject to the restrictions of Rule 5131.

- **Anti-dilution exemption for Rule 5131.** Rule 5130 allows "restricted persons" that are existing equity owners of an issuer to purchase new issue securities of the issuer in a public offering in order to maintain their equity ownership position, subject to specified conditions including (1) the restricted person has held an equity ownership interest in the issuer for at least one year prior to the effective date of the new issue offering; (2) the sale of the new issue does not increase the restricted person's percentage equity ownership in the issuer above the ownership level as of three months prior to the filing of the registration statement in connection with the offering; (3) the sale of the new issue to the restricted person does not include any special terms; and (4) the acquired new issue securities are not sold, transferred, assigned, pledged or hypothecated for three months following the effective date of the offering. FINRA adopted similar anti-dilution provisions under Rule 5131 for executive officers and directors of public companies and covered non-public companies who are subject to Rule 5131's "spinning" prohibition so that such executive officers and directors are able to maintain the same equity ownership level that they held prior to a public offering.
- **Family offices and family investment vehicles.** The amendments expand the definition of "family investment vehicle" (FIV) under Rule 5130 to align with the concept of the family office exclusion under the Investment Advisers Act of 1940 (the Advisers Act), including to capture family investment vehicles that invest on behalf of multiple generations of a family as well as key employees of the family office. Investments in a FIV by portfolio managers and other key employees of a family office who are not an immediate family member is a common element of most family office structures that comply with the Family Office Rule under the Advisers Act. Under the amendment, such individuals are no longer treated as "restricted persons" subject to the restrictions of Rule 5130. However, the requirement that an immediate family member have sole investment authority with respect to purchases and sales of securities by a family office will effectively mean that most family offices will remain restricted persons subject to the restrictions of Rule 5130.
- **Lock-up agreements.** Under Rule 5131(d)(2), lock-up agreements with officers and directors of an issuer in connection with a new issue must require a public announcement at least two business days before release or waiver of any lock-up or other restriction on the transfer of the issuer's shares, except where the release or waiver is for a transfer that is not for consideration and the transferee agrees in writing to be bound by the same lock-up terms. The amendments extend this exception to include transfers to immediate family members (irrespective of consideration) and provide that disclosure of a release or waiver in a publicly filed registration statement in connection with a secondary offering satisfies the announcement requirement to the extent it meets the timing requirements of the rule.

Looking Ahead

The new rules became effective on January 1, 2020. Broker-dealers should update their customer materials to reflect the rule amendments, and the updated documentation should be completed by both new investors and existing investors. In addition, investment advisors who advise client accounts and investment funds that invest in new issues should also update their client onboarding materials and subscription documents to reflect the modified rules.

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Anna T. Pinedo is a partner in Mayer Brown's New York office and a member of the Corporate & Securities practice. She concentrates her practice on securities and derivatives. Anna represents issuers, investment banks/financial intermediaries and investors in financing transactions, including public offerings and private placements of equity and debt securities, as well as structured notes and other hybrid and structured products.

She works closely with financial institutions to create and structure innovative financing techniques, including new securities distribution methodologies and financial products. She has particular financing experience in certain industries, including technology, telecommunications, healthcare, financial institutions, REITs and consumer finance. Anna has worked closely with foreign private issuers in their securities offerings in the United States and in the Euro markets. She also works with financial institutions in connection with international offerings of equity and debt securities, equity- and credit-linked notes, and hybrid and structured products, as well as medium term note and other continuous offering programs.

In the derivatives area, Anna counsels a number of major financial institutions acting as dealers and participants in the commodities and derivatives markets. She advises on structuring issues as well as on regulatory issues, including those arising under the Dodd-Frank Act. Her work focuses on foreign exchange, equity and credit derivatives products, and structured derivatives transactions. Anna has experience with a wide range of transactions and structures, including collars, swaps, forward and accelerated repurchases, forward sales, hybrid preferred stock and off-balance sheet structures. She also has advised derivatives dealers regarding their Internet sites and other Internet and electronic signature/delivery issues, as well as on compliance matters.

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