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Changes to FINRA Rules 5130 and 5131 Go Effective – Considerations for Private Fund Managers

January 2, 2020

On November 5, 2019, the SEC approved changes to FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) and Rule 5131 (New Issue Allocations and Distributions). FINRA announced that the changes would become effective on January 1, 2020, in Regulatory Notice 19-37.

FINRA Rules 5130 and 5131 protect the integrity of public offerings for "new issue" securities (*i.e.* initial public offerings of equity securities) by, among other things, ensuring that member firms make *bona fide* public offerings at the offering price, do not withhold securities for their benefit or the benefit of industry insiders, including employees and industry professionals, or award them to persons who can give them future business (a practice known as "spinning").

Specifically, Rule 5130 provides that, except as otherwise permitted, (i) a member firm may not continue to hold new issue securities acquired as an underwriter, selling group member, or otherwise, and (ii) a member or person associated with a member may not sell a new issue security to an account in which a "restricted person" has a "beneficial interest." A "restricted person" includes, among other categories of persons, (i) a broker-dealer, (ii) an owner or employee of a broker-dealer, (iii) a portfolio manager, and (iv) a finder or fiduciary with respect to the new issue security. "Beneficial interest" means any economic interest, including the right to share in profits or losses.[1] Rule 5131 prohibits the allocation of new issue securities to an executive officer or director of a public company or a covered non-public company, in each case that is a former, current or prospective investment banking client of the member ("anti-spinning" provision), and imposes other restrictions and conditions on trading.

The amendments make a number of changes to the terms, conditions and exceptions to the rules as follows:

Foreign Investment Company Exemption

Rules 5130 and 5131 exempt sales to a foreign investment company, provided it is listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority and no person owning more than five percent of the shares of the foreign investment company is a restricted person. The amendments provide an alternative to the five-percent limitation where the foreign investment company has 100 or more direct investors or 1,000 or more indirect investors. The foreign investment company also cannot have been formed for the purpose of permitting restricted persons to invest in new issues.

Exemption for U.S. and Foreign Employee Retirement Benefits Plans

The amendments expand the exemption for U.S. employee retirement benefits plans and codify previous relief granted to foreign employee retirement benefits plans[2] for both rules. The provision exempts an employee retirement benefits plan organized under and governed by U.S. or foreign law, provided the plan or family of plans: (i) has at least 10,000 plan participants and beneficiaries and $10 billion in assets; (ii) is operated in a non-discriminatory manner (*i.e.* a wide range of employees, regardless of income or position, are eligible to participate without further amendment or action by the plan sponsor); (iii) is administered by a trustee or manager that has a fiduciary obligation to administer the plan in the best interests of participants and beneficiaries; and (iv) is not sponsored solely by a broker-dealer.

Issuer-Directed Securities Exemption

FINRA clarified and made consistent the exemptions for issuer-directed allocations of new issue securities under both rules. The exemption extends to securities directed in writing by the issuer, its affiliates or selling shareholders. FINRA clarified that the exemption applies to securities directed by a *single* affiliate or selling shareholder. The amendments add that the allowance for issuer-directed allocations to restricted persons who are employees or directors of the issuer, its parent, subsidiary or affiliate extends to franchisees.

Foreign Offerings and Allocations

The definition of "new issue" security for both rules was amended to exclude an offering pursuant to Regulation S of the Securities Act of 1933 or otherwise made outside of the U.S. and its territories, provided the securities are not concurrently registered for sale in the U.S. For concurrent U.S. offerings, supplementary material 5130.01 and 5131.05 clarify that the rules do not prohibit allocations of new issue securities to non-U.S. persons by foreign broker-dealers that are not FINRA member firms participating in the underwriting syndicate, provided the decisions are not made at the direction or request of a FINRA member firm or its associated persons.

Exclusion for Special Purpose Acquisition Companies (SPACs)

The term "new issue" security was further amended to exclude offerings SPACs, because they have limited potential to trade at an immediate premium to the public offering price (like business development companies, direct participation programs, real estate investment trusts, closed-end funds, and preferred and other securities also excluded from the definition).

Family Investment Vehicles

A person with investment authority for a "collective investment account" that is a "family investment vehicle" is not a "restricted person" for purposes of Rule 5130. The amendments align the definition of a "family investment vehicle" with the definition of a "family office" under the Investment Advisers Act of 1940, so that a "family investment vehicle" is defined as a legal entity that is beneficially owned solely by "immediate family members" (as defined in Rule 5130), "family members" (as defined under the Advisers Act) and/or "family clients" (as defined under Advisers Act). FINRA removed a condition that would have required the person with investment authority to be an immediate family member.

Sovereign Entities

The amendments exclude "sovereign entities" from the category of owners of broker-dealers that are "restricted persons" under Rule 5130. The rule defines the term "sovereign entity" as "a sovereign nation or a pool of capital or an investment fund or other vehicle owned or controlled by a sovereign nation and created for the purpose of making investments on behalf or for the benefit of the sovereign nation." A "sovereign nation" is defined as "a sovereign nation or its political subdivisions, agencies or instrumentalities." The exclusion does not apply to a sovereign entity's affiliates or related personnel that are otherwise restricted. Accordingly, while a sovereign entity itself would be excluded from the definition of a restricted person, a broker-dealer owned by the sovereign entity or a portfolio manager of a sovereign wealth fund would continue to be a restricted person.

Lock-Up Agreements, Transfers and Notices

Rule 5131 requires that any lock-up agreement, or other restriction on the transfer of shares by an officer or director of the issuer in connection with a new issue security must provide for notice of a release from, or waiver of, such restriction by the book-running lead manager to the issuer and also announcement to the public at least two days prior to the release or waiver of the restriction. The rule provides an exception where the release or waiver is for a transfer not for consideration and the transferee has agreed in writing to be bound by the terms of the restriction. The amendments extend the exception to include a transfer to an immediate family member (as defined in Rule 5130) who agrees in writing to be bound by the restriction. In addition, supplementary material 5131.03 was amended to include previous guidance that disclosure of the release or waiver in a filed registration statement for a secondary offering satisfies the public announcement requirement.

Allocations to Officers and Directors of Unaffiliated Charitable Organizations

Prior to the amendments, the restriction on allocations to executive officers and directors (and persons materially supported by them) of covered non-public companies under Rule 5131 captured officers and directors of charitable organizations. Because these organizations present a low risk of improper spinning arrangements, the definition of "covered non-public company" was amended to exclude "unaffiliated charitable organizations," as defined in the rule. Accordingly, an executive officer or director of a tax-exempt entity organized under Section 501(c)(3) of the U.S. Internal Revenue Code that is not affiliated with the FINRA member making the allocation decision is now not subject to the restriction.

Anti-Dilution Provision to Rule 5131

The amendments add an anti-dilution exception similar to the one contained in Rule 5130 to the anti-spinning restriction in Rule 5131. The provision allows an executive officer or director (or materially supported person) of a public company or a covered non-public company who has held an equity ownership interest in the issuer for at least a year prior to the effective date of the offering to maintain the person's percentage equity ownership in the issuer up to his or her existing interest three months prior to the filing of the registration statement provided certain other conditions are met.

Managers are advised to review and revise their new issues questionnaires and related documentation to reflect the changes to Rules 5130 and 5131.

Please do not hesitate to reach out to your regular Proskauer contact or any of the authors for more information or assistance regarding this Alert.

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[1] The receipt of a management or performance fee or allocation for operating a collective investment account or other fee for acting in a fiduciary capacity is not considered a beneficial interest in the account.

[2] *See e.g.,* Letter from Afshin Atabaki, FINRA, to Christopher M. Wells, Proskauer Rose LLP, dated November 2, 2012; Letter from Gary L. Goldsholle, FINRA, to Edward A. Kwalwasser, Proskauer Rose LLP, dated December 7, 2010.

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