FINRA Rule 5131 Application of the *De Minimis* Exception to Bank Omnibus Accounts

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FINRA Rule 5131 restricts the allocation of new issue equity securities ("IPO shares") to an account for the benefit of an executive officer or director (a "Covered Person")[1] of a public company or a covered non-public company, as such terms are defined by Rule 5131.[2] For the reasons discussed below, we believe the *de minimis* exception under the rule should apply with respect to transactions effected on an aggregate basis through an omnibus account by a bank or investment adviser with a FINRA member firm.

FINRA Rule 5131, which was approved by the SEC on September 29, 2010, is intended to prevent "quid pro quo" and other specified arrangements in connection with the distribution of IPO shares by FINRA member firms. Among other things, the rule prohibits a member from allocating IPO shares to executive officers or directors of companies who may be in a position to direct investment banking business to the member – known as "spinning." Specifically, Rule 5131(b)(1) provides that:

> No member or person associated with a member may allocate [IPO shares] 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:
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> A. if the company is currently an investment banking services client of the member or the member has received compensation from the company for investment banking services in the past 12 months;
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> B. if the person responsible for making the allocation decision knows or has reason to know that the member intends to provide, or expects to be retained by the company for, investment banking services within the next 3 months; or
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> C. on the express or implied condition that such executive officer or director, on behalf of the company, will retain the member for the performance of future investment banking services.

The restrictions on the allocation of IPO shares to the account of a Covered Person under Rule 5131 do not apply to an account in which the collective interests of all Covered Persons are below a specified threshold. Some U.S. and foreign private banks and investment advisers place orders with FINRA member firms to acquire IPO shares on behalf of a number of clients through an omnibus account in the name of the bank or adviser.

[1] The term also includes persons materially supported by such officer or director.

[2] FINRA Rule 5131(e)(1) defines the term "public company" as "any company that is registered under Section 12 of the [Securities Exchange Act of 1934] or files periodic reports [with the U.S. Securities and Exchange Commission ("SEC" or the "Commission")] pursuant to Section 15(d) thereof." Rule 5131(e)(3) defines the term "covered non-public company" as "any non-public company satisfying the following criteria: (i) income of at least [US]$1 million in the last fiscal year or in two of the last three fiscal years and shareholders' equity of at least [US]$15 million; (ii) shareholders' equity of at least US$30 million and a two-year operating history; or (iii) total assets and total revenue of at least [US]$75 million in the latest fiscal year or in two of the last three fiscal years." These criteria are based on quantitative initial listing standards for a U.S. national securities exchange, such as NASDAQ, which FINRA considers a suitable proxy for the types of customers that are likely to be targeted by member firms for investment banking services.

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The "*de minimis* exception" under Rule 5131(b)(2) provides, in pertinent part:

> The prohibitions [in paragraph (b)(1)] shall not apply to allocations of shares of a new issue to any . . . account in which the beneficial interests of executive officers and directors of the company and persons materially supported by such executive officers and directors in the aggregate do not exceed 25% of such account.[3]

The *de minimis* exception is modeled after a similar exemption contained in FINRA Rule 5130, which prohibits member firms from selling IPO shares to industry insiders such as broker-dealers, investment advisers and their associated persons ("restricted persons").[4] The "*de minimis* exemption" under Rule 5130 permits some participation by restricted persons in IPO shares through investments in hedge funds and other accounts in which the interests of restricted persons in the aggregate are limited to 10 percent. The exemption, thus, reserves the vast majority of IPO shares for investors that are not closely connected to the financial services industry. The nature of the account as a hedge fund or other type of collective investment vehicle and the inability of a restricted person to direct investments for the account were proposed as further limitations on the exemption. However, in the end, each of these restrictions was omitted from the rule.[5] Accordingly, it would appear that the principal consideration behind the exception is to ensure the allocation of IPO shares to accounts in which the overall beneficial interests of investors that are not Covered Persons of public companies or covered non-public companies is at least 75 percent.

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[3] The Rule permits a member firm to rely on a written representation obtained from the beneficial owner of an account, or a person authorized to represent such person, as to whether the account is for the benefit of a Covered Person, and if so, the name of the company on whose behalf he or she serves. The representation must be obtained on an annual basis. *See* FINRA Rule 5131, supplemental material .02. FINRA member firms may use third-party vendors, such as Dealogic or Ipreo to procure annual certifications.

[4] The rule provides, in pertinent part, that "[a] member or a person associated with a member may not sell, or cause to be sold, a new issue to any account in which a restricted person has a beneficial interest, except as otherwise permitted herein." Rule 5130(c)(4) provides an exemption for "sales to and purchases by . . . . [a]n account if the beneficial interests of restricted persons do not exceed in the aggregate 10% of such account." Rule 5130 is meant to ensure that public offerings of IPO shares are made predominantly to public investors – not industry insiders.

[5] As originally proposed in NASD Rule 2790 (the forerunner to FINRA Rule 5130), the *de minimis* exemption would have applied only to "*[a] collective investment account* . . . that is beneficially owned in part by restricted persons provided that such restricted persons in aggregate own less than 5% of such account." *See Proposed Rule 2790, Trading in Hot Equity Offerings*, File No. SR-NASD-99-60 (Oct. 14, 1999) (the "*Rule 5130 Proposing Release*") (emphasis added). The term "collective investment account" was defined, in pertinent part, as "any hedge fund, investment partnership, investment corporation, or any other collective investment vehicle that manages assets of other persons." *Id*. at 4. The term, therefore, referred to an account of a single entity or enterprise that itself represented the interests of multiple beneficial owners. An account by a bank, broker-dealer or investment adviser representing the interests of numerous individuals or entities arguably was not contemplated by the more restrictive definition. Indeed, commentary on the application of the *de minimis* exemption in the *Rule 5130 Proposing Release* referred exclusively to hedge funds and other, similar investment vehicles. However, in the second amendment to the proposed rule, the *de minimis* exemption was reformulated to refer more broadly to "*an account* that is beneficially owned in part by restricted persons, provided that such restricted persons in the aggregate own less than 5% of such account," with additional restrictions placed on a restricted person's power to direct the investments of the account and the number of shares – 100 – that could be allocated to the benefit of a restricted person. *See Restrictions on the Purchase and Sale of Initial Equity Public Offerings, Amendment No. 2*, File No. SR-NASD-99-60 (Oct. 10, 2000) (emphasis added). The rule as adopted applies to "[a]n account if the beneficial interests of restricted persons do not exceed in the aggregate 10% of such account." The term "beneficial ownership" was replaced by the term "beneficial interest" to clarify that the provision applies to the more attenuated interests of restricted persons in collective investment accounts. However, the reference to all types of accounts remained, while the restrictions on investment authority and number of shares were removed. The final rule also retained essentially unchanged the term "collective investment account" for the purpose of counting the managers of such accounts among the category of restricted persons subject to the rule's prohibitions, which underscores the notion that the exemption is intended to apply to a broader array of accounts than collective investment accounts. FINRA and the SEC, nevertheless, continued to refer only to hedge funds and other investment entities in describing the *de minimis* exemption. *See e.g., Restrictions on the Purchase and Sale of Initial Equity Public Offerings, Amendment No. 4*, File No. SR-NASD-99-60 (Jul. 27, 2002) ("NASD is increasing the percentage *of a fund* that may be owned by restricted persons under the *de minimis* exemption from 5% to 10%.") (emphasis added). *See also, Order Approving Proposed Rule Change and Amendment Nos. 1 Through 4 Thereto and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 5 Thereto by the National Association of Securities Dealers, Inc. Relating to Restrictions on the Purchases and Sales of Initial Offerings of Equity Securities*, SEC Release No. 34-48701 (Oct. 23, 2003). However, in light of the change made to the express language of the exemption with respect to "account," and the removal of all conditions other than the aggregate percent limitation on beneficial interests of restricted persons, it is reasonable to assume that the focus on hedge funds was exemplary rather than restrictive. Other types of "accounts" with multiple beneficiaries should be eligible for the *de minimis* exemption, provided the total beneficial interest of restricted persons in the account is limited to 10 percent in accordance with the exemption.

Since the *de minimis* exception in FINRA Rule 5131 is modeled after the *de minimis* exemption in Rule 5130, the same objective should pertain – i.e., the limitation on the total percentage of IPO shares that may be allocated to accounts for the benefit of Covered Persons of public companies and covered non-public companies. Accordingly, we believe that individuals who are Covered Persons of U.S. public companies or covered non-public companies should be able to participate in allocations of IPO shares purchased through an omnibus account of a bank or investment adviser provided that the policies and procedures of the bank or investment adviser with respect to the omnibus account limit the aggregate beneficial interests of all customers that are Covered Persons of such companies to 25 percent of the IPO shares acquired by the account.[6]

The prohibition in Rule 5131 does not extend to allocations of IPO shares to Covered Persons of companies that are not clients or prospective clients of the member firm. Therefore, a bank or investment adviser could elect to identify to a member firm the specific companies with which the Covered Persons are associated in connection with an order for IPO shares. If the identified companies are not clients or prospective clients, the member is free to sell the securities to the customer. This may prove to be impractical, however, and many firms use standard forms by dealogic, Ipreo and other intermediaries to qualify accounts, which do not provide for the identification of specific affiliations. In light of the broader participation in IPO shares that could be made available to customers that are Covered Persons upon disclosure of their company affiliations, a bank or investment adviser utilizing the *de minimis* exception with respect to aggregate orders would be well advised to obtain the consent of each Covered Person of a public company or covered non-public company to withhold information pertaining to the person's affiliation for the purpose of obtaining IPO shares in the U.S. with the understanding that the person's eligibility to receive IPO shares may be limited in accordance with the *de minimis* exception.

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Please contact us if you would like to discuss the issues raised herein in more detail.

[6] On its face, the 25 percent limit on beneficial interests of Covered Persons under Rule 5131(b)(2) applies with respect to all transactions in an account – not just transactions in IPO shares. However, FINRA has reaffirmed the procedural relief available under the *de minimis* exemption in Rule 5130 to enable hedge funds with aggregate beneficial interests of restricted persons in excess of 10 percent to qualify for the exemption to the extent that the fund implements procedures to limit the total interests of restricted persons in IPO transactions effected for the fund to 10 percent. Tel. call with FINRA staff, Office of General Counsel, FINRA on Jul. 5, 2011. The same consideration should permit the Account to participate in IPO offerings to the extent that the aggregate interest of Covered Persons of a public company or covered non-public company in all transactions in IPO shares is limited to 25 percent, notwithstanding a greater involvement by such persons in other types of transactions.