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Client Alert Commentary

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SEC Approves Amendments to FINRA's New Issue Rules

The amendments expand certain exemptions and provide additional guidance under Rules 5130 and 5131 with respect to equity IPO allocations.

On December 19, 2019, the Financial Industry Regulatory Authority (FINRA) issued Regulatory Notice 19-37 (RN 19-37) to summarize and provide additional context to the changes to FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) and FINRA Rule 5131 (New Issue Allocations and Distributions) (together, the Rules) that were approved by the US Securities and Exchange Commission (SEC) on November 5, 2019. The amendments to the Rules became effective on January 1, 2020.

The amendments respond to comments initially received by FINRA following the publication of Regulatory Notice 17-14, which requested comment more generally on the effectiveness and efficiency of FINRA's "rules, operations and administrative processes governing broker-dealer activities related to the capital-raising process and their impact on capital formation."

This *Client Alert* highlights changes to the Rules relating to the allocation of securities in equity IPO.

Foreign Investment Companies

Old Rules

Prior to the amendments, an investment company organized under the laws of a foreign jurisdiction often had difficulty confirming whether it could rely on the general exemption provided under Rule 5130(c)(6) (and by reference, Rule 5131(b)(2)) if it could not adequately ascertain whether any one particular investor owned more than 5% of its shares. The 5% threshold is intended to prevent foreign investment companies with concentrated ownership interests of restricted persons from purchasing new issues. However, it is often operationally impractical for a foreign investment company to determine whether an investor owns more than 5% of its shares since an investor may acquire his or her interest through an intermediary that holds multiple investors' shares in an omnibus or nominee account. Further, an investor may acquire shares of a foreign investment company through multiple intermediaries or through multiple omnibus or nominee accounts at the same intermediary.

New Rules

The amended Rules now contain alternative conditions to establish that a foreign investment company is widely held for purposes of the general exemption under Rules 5130 and 5131. Specifically, a foreign

investment company may also rely on the exemption if it (i) has either 100 or more direct investors or 1,000 or more indirect investors; and (ii) was not formed for the specific purpose of permitting restricted persons to invest in new issues.

Although commenters had sought a complete exemption for foreign investment companies given that they are highly regulated in their own home jurisdictions, FINRA declined this request. Instead, FINRA reiterated its view that the alternative conditions provided by the amended Rules are narrowly tailored, reasonable, and appropriate to address industry concerns.

Employee Retirement Benefits Plans

Old Rules

Prior to the amendments, Rule 5130 did not include a general exemption for US or foreign employee retirement benefits plans, although FINRA had previously granted exemptions on a case-by-case basis. Because employee retirement benefits plans may invest in assets on behalf of potentially hundreds of thousands of participants and beneficiaries, such plans may be unable to determine whether such participants are restricted persons under Rule 5130 or a "covered person" under Rule 5131, making it difficult for them, as a practical matter, to assess whether they may be allocated new issues under the Rules.

New Rules

A US or foreign employee retirement benefits plan (even if not a qualified plan under Section 401(a) of the Internal Revenue Code) will now qualify for a general exemption under Rule 5130(c)(8) and, by reference, Rule 5131(b)(2), if the plan satisfies all of the conditions set forth therein. In particular, the plan must:

- Have a minimum of 10,000 plan participants and beneficiaries and US$10 billion in assets
- Be operated in a non-discriminatory manner insofar as a wide range of employees, regardless of income or position, are eligible to participate without further amendment or action by the plan sponsor
- Be administered by trustees or managers that have a fiduciary obligation to administer the funds in the best interests of the participants and beneficiaries
- Not be sponsored solely by a broker-dealer

Some commenters to the proposed amendments advocated the full removal of all thresholds for plan participants, beneficiaries, and assets as potentially arbitrary and exclusionary of foreign plans that fall just below the thresholds. However, FINRA maintains that the quantitative thresholds are necessary and reasonable, and indicated that it will continue to consider exemptive relief on a case-by-case basis for foreign employee retirement benefits plans that do not meet the specified thresholds.

Issuer-Directed Securities

Old Rules

Prior to the amendments, Rules 5130(d) and 5131.01 each contained exemptive provisions for allocations of new issues that were expressly directed by the issuer in writing and met certain other specified

conditions. These provisions were included because the regulatory concerns that the Rules are designed to address are not present with respect to allocations of securities that are not controlled by a FINRA member. However, these two exemptions were not identical (*e.g.*, Rule 5131 also exempted allocations directed by affiliates and selling shareholders, while Rule 5130 was technically limited to allocations only by the issuer), which led to unnecessary confusion and requests for interpretive guidance.

New Rules

In amending the provisions, FINRA agreed with commenters on the proposed amendments that a conforming change to Rule 5130(d) to more closely align the Rule with the issuer-directed provision in Rule 5131.01 would provide regulatory consistency without negatively impacting investor protection or the integrity of the market for new issues.

In addition, in response to comments submitted by the Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association (ABA),[1] Rule 5130(d)(1)(B) now expressly recognizes that the issuer-directed allocation exception may be relied on for allocations to employees or directors of a franchisee in a franchisor/franchisee relationship. FINRA also confirmed the continued applicability of the general exemptions, such as the *de minimis* exemptions under Rule 5130(c)(4) and Rule 5131(b)(2), to allocations by issuers to persons that do not meet the precise requirements of the issuer-directed exemption.[2]

Foreign Offerings and Independent Allocations by Foreign Non-Member Broker-Dealers

Old Rules

The definition of "new issue" under Rule 5130(i)(9) and, as incorporated, under Rule 5131(e)(7) did not exclude foreign offerings, such as initial public offerings made outside the United States under Regulation S of the Securities Act of 1933 (Securities Act). Moreover, it was unclear as to whether the Rules applied to allocations to non-US persons by foreign non-FINRA member broker-dealers when such foreign broker-dealers participated together in an underwriting syndicate with FINRA member broker-dealers.

New Rules

The Rules have now been amended to expressly carve out of the new issue definition non-US offerings conducted pursuant to Regulation S or otherwise made outside of the United States or its territories, so long as the securities offered and sold in any such offering are not registered under the Securities Act for sale in the United States in connection with a concurrent US IPO. In addition, while the exclusion for non-US offerings would not apply if the offered securities are concurrently registered for sale in the US, FINRA agreed to the ABA's request to add guidance to clarify how the Rules would be applied to foreign non-FINRA member broker-dealers. Specifically, the new Supplementary Material provided under Rules 5130.01 and 5131.05 clarifies that the Rules do not apply to an allocation made by a foreign non-FINRA member broker-dealer to a non-US person, provided the allocation is not directed or otherwise requested by a FINRA member or an associated person of a FINRA member.

SPACs

Old Rules

Offerings by special purpose acquisition companies (SPACs) were not excluded from the definition of "new issue," despite their similarities to offerings by registered closed-end investment companies, business development companies, direct participation programs, and real estate investment trusts, each of which were specifically excluded from the definition.

New Rules

As requested by the ABA, FINRA agreed that offerings by SPACs have similar characteristics to those offerings that are currently excluded from the definition of "new issue," and amended the definition of "new issue" in Rule 5130(i)(9) to also exclude offerings by SPACs.

Family Investment Vehicles

Old Rules

The definition of "family investment vehicle" was limited to a legal entity beneficially owned solely by immediate family members as such term is defined in Rule 5130.

New Rules

In order to align the definition of family investment vehicle with the definitions relating to family offices under the Investment Advisers Act of 1940 (Advisers Act), FINRA has amended the definition to also include "family members" and "family clients" as such terms are defined in Advisers Act Rule 202(a)(11)(G)-1.

As initially proposed, the amendments contained a limitation that if the beneficial owners of a family investment vehicle included family clients (including possible non-family members), the person who has the sole authority to buy or sell securities for such an entity must be 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)) for the entity to be considered a family investment vehicle. Commenters on the proposed amendments, however, objected to the limitation on the grounds that, in practice, family offices often delegate authority to investment professionals that are not family members. FINRA acknowledged the validity of these objections and did not include the limitation in the final amendments.

Sovereign Entities

Old Rules

The definition of "restricted person" set forth in Rule 5130(i)(10(E) includes (subject to limited exceptions) any person listed or required to be listed as a direct or indirect owner of a broker-dealer on its Form BD.

New Rules

FINRA acknowledged that the restricted person definition inadvertently captured sovereign entities (and their associated investment vehicles) if their ownership interest in a broker-dealer exceeded the Form BD disclosure thresholds. To address the unintended impact of this provision, which resulted in the inability of certain sovereign entities to receive IPO allocations, FINRA has amended the restricted person definition to exclude sovereign entities from restricted person status solely by virtue of their ownership interest in a

broker-dealer. To implement this exclusion, FINRA added to Rule 5130(i) new provisions that define "sovereign entity" and "sovereign nation." In particular:

- Rule 5130(i)(11) has been added to define the term "sovereign entity" for purposes of the Rule 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."

- Rule 5130(i)(12) has been added to define the term "sovereign nation" for purposes of the Rule as "a sovereign nation or its political subdivisions, agencies or instrumentalities."

FINRA cautions, however, that the exclusion does not apply to affiliates of sovereign entities that are otherwise restricted persons. Accordingly, while a sovereign entity that directly or indirectly owns a broker-dealer would not be considered a restricted person under the amended Rule, the broker-dealer itself would continue to be a restricted person under Rule 5130.

Lock-Up Agreements

Old Rules

Rule 5131 requires that any lock-up agreement applicable to the officers and directors of an issuer entered into in connection with a new issue stipulate that, at least two business days before the release or waiver of any lock-up or other restriction on the transfer of the issuer's shares, the book-running lead manager must notify the issuer of the impending release or waiver and the impending release or waiver must be announced through a major news service. Rule 5131 provided a limited exception from the requirement in cases in which the release or waiver was for a transfer that was not for consideration and the transferee agreed in writing to be bound by the same lock-up agreement terms in place for the transferor.

New Rules

Acknowledging that certain transfers to immediate family members may be "for consideration" but still not require public announcement, FINRA has agreed to amend Rule 5131 to also exclude from the public announcement requirement transfers (with or without consideration) to immediate family members, provided that the transferee has agreed in writing to be bound by the same lock-up agreement terms in place for the transferor.

In addition, existing guidance set forth in FINRA Regulatory Notice 10-60 regarding the disclosure of a lock-up agreement release or waiver in a publicly filed registration statement has been codified in response to commenter requests. Specifically, FINRA has confirmed that the requirement for an announcement through a major news service can be satisfied by the disclosure of a release or waiver in a publicly filed registration statement in connection with a secondary offering.

Finally, FINRA added guidance (previously provided on an informal basis) that the public announcement requirement does not apply to a release or waiver of a lock-up agreement prior to the effective date of the offering if the existence of the lock-up agreement has not yet been publicly disclosed. Thus, for example, the release or waiver of a lock-up agreement entered into before the public filing of a registration statement disclosing the existence of the lock-up agreement would not trigger Rule 5131(d)(2)'s public announcement requirement.[3]

Unaffiliated Charitable Organizations

Old Rules

The "spinning" prohibition under Rule 5131 applies to certain executive officers and directors of public companies and "covered non-public companies" that have an investment banking relationship with a FINRA member firm. As written, this provision could include executive officers and directors of charitable organizations, although FINRA now states that this result was not intended.

New Rules

"Unaffiliated charitable organizations" have now been excluded from the definition of "covered non-public company" in Rule 5131. As set forth in Rule 5131(e)(9), an unaffiliated charitable organization is defined as "a tax-exempt entity organized under Section 501(c)(3) of the Internal Revenue Code that is not affiliated with the member and for which no executive officer or director of the member, or person materially supported by such executive officer or director, is an individual listed or required to be listed on Part VII of Internal Revenue Service Form 990 (*i.e.,* officers, directors, trustees, key employees, highest compensated employees and certain independent contractors)."

Anti-Dilution

Old Rules

Rule 5130 allows restricted persons that are existing equity owners of an issuer to purchase shares of the issuer in an IPO in order to maintain their equity ownership position (subject to certain conditions, including a three-month lock-up on sale or transfer of the shares purchased). However, Rule 5131 did not include a similar anti-dilution provision for executive officers and directors who are subject to the prohibition on spinning set forth in Rule 5131(b).

New Rules

To address the asymmetry between the Rules, an anti-dilution provision has been added to Rule 5131, similar to the provision in Rule 5130. Specifically, the amendment allows an executive officer or director of a public company or a covered non-public company (or a person materially supported by such a person) to retain the 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 the other conditions of the Rule are met. In its comments, the ABA questioned whether there was a compelling need for a lock-up requirement in either the existing anti-dilution provision in Rule 5130 or the proposed anti-dilution provision in Rule 5131 and argued for its removal. In response, FINRA insisted that the lock-up requirement continues to be necessary to prevent restricted persons from abusing the anti-dilution provisions in order to circumvent the Rule's restrictions.

FINRA, however, did agree to the ABA's request to include guidance confirming that it is "appropriate to consider convertible securities, options and warrants for purposes of determining whether a person satisfies the one-year holding period and the three-month equity ownership calculation period under the Rule, provided that the person had the ability to convert or exercise such securities during the course of the applicable period."[4]

Conclusion

Although FINRA did not agree to all the requested modifications proposed by industry commenters, the amendments provide helpful clarifications and changes, and we hope that FINRA will further engage with the industry to explore other ways of promoting capital formation and improving the capital-raising process.

Takeaways for FINRA Member Firms and Private Funds

Firms should look to update their FINRA Rule 5130 and 5131 new account documentation and certificates, and modify related internal policies and procedures, to reflect the new definitions, interpretive guidance, and expanded exclusions. Private funds should also look to update their subscription agreements in a similar manner.

In this regard, we note that FINRA recently released its Annual Risk Monitoring and Examination Priorities Letter, highlighting the areas of focus for its risk monitoring, surveillance, and examination programs in 2020. FINRA indicated that its priorities this year will include focusing on firms' IPO practices and compliance with the obligations imposed under Rules 5130 and 5131. In particular, FINRA stated that it may consider various factors when reviewing a firm's IPO practices, including:

- Whether the firm has procedures in place to detect and address potential instances of flipping
- Whether the firm, when acting as a book-running lead manager for an IPO, reports aggregate retail demand to the issuer's pricing committee and how the firm calculates such aggregate retail demand
- How the firm develops and implements its IPO allocation methodologies
- What controls the firm has in place to prevent allocations to restricted persons
- What controls the firm has in place to detect and address potential instances of spinning
- How the firm obtains, records, and verifies customer information for individuals receiving IPO allocations

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Endnotes

1 The ABA letter was drafted by members of the ABA's FINRA Corporate Financing Rules Subcommittee, including Dana Fleischman (Subcommittee Chair), Steve Wink, and Gail Neely of this firm.

2 *See* RN 19-37 n. 9.

3 *See* RN 19-37, n. 14.

4 *See* RN 19-37, n. 18.