

CLIENT ALERT

# FINRA Proposes Amendments to its New Issue Rules

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The Financial Industry Regulatory Authority, Inc. (“FINRA”) has filed with the Securities and Exchange Commission (“SEC”) a proposed rule change to amend FINRA Rules 5130 and 5131, which govern the offer and sale of New Issue securities,<sup>1</sup> to exempt additional persons and types of offerings from the restrictions in the rules, and otherwise make modifications to address certain issues with the rules in their current form.<sup>2</sup> The SEC has published a notice to solicit comments on the proposed rule change by interested persons.<sup>3</sup> The comment period ends August 29, 2019.

If approved by the SEC, FINRA will announce the effective date of the proposed rule change in a FINRA Regulatory Notice to be published no later than 60 days following SEC approval, and the effective date will be no later than 30 days following the publication of that Regulatory Notice.

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<sup>1</sup> “New Issue” means for purposes of FINRA Rules 5130 and 5131, any initial public offering (“IPO”) of an equity security as defined in Section 3(a)(11) of the Securities Act of 1933, as amended, made pursuant to a registration statement or offering circular, with some exceptions.

<sup>2</sup> SR-FINRA-2019-022. 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).

<sup>3</sup> SEC Release 34-86558, 84 Fed. Reg. 39,029 (Aug. 8, 2019).

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### Background

FINRA Rule 5130 precludes broker-dealers from selling New Issue securities to accounts in which Restricted Persons as defined in that Rule have a beneficial interest. The term “Restricted Person” includes the following categories of persons: (1) broker-dealers; (2) broker-dealer personnel; (3) finders and fiduciaries in securities offerings; (4) portfolio managers; (5) persons owning a broker-dealer; and (6) in certain circumstances, persons materially supported by, or the immediate family members of persons in (1) through (5).<sup>4</sup> In addition, FINRA Rule 5131 restricts broker-dealers from selling New Issue securities to accounts that are beneficially owned by persons that are executive officers or directors of public companies and certain covered non-public companies<sup>5</sup> having specified relationships with the broker-dealer, and persons materially supported by such persons (“Covered Persons”). For purposes of the Rules, beneficial interest means any economic interest, such as the right to share in profits or losses. Since FINRA Rules 5130 and 5131 look to the beneficial owners of an account, persons responsible for making investments in New Issue securities for accounts with multiple beneficial owners, such as managers of private investment funds, need to determine whether the beneficial owners of such accounts are Restricted Persons or Covered Persons.

Both Rules provide exemptions from these general prohibitions for certain types of offerings and purchasers.

### Foreign Pension Plan Exemption

FINRA Rule 5130(c)(7) currently provides a general exemption for sales of New Issue securities to an Employee Retirement Income Security Act (“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.<sup>6</sup> Foreign Employee retirement benefits plans are not subject to ERISA so they do not qualify for the exemption. Because such plans often invest on behalf of a large number of participants and beneficiaries, such plans may be unable to determine whether persons with a beneficial interest are Restricted Persons under FINRA Rule 5130 or Covered Persons under Rule 5131. As a result, such plans may find it impossible to determine whether they may invest in New Issues. FINRA proposes to add a general exemption for employee benefit plans organized under and governed by the laws of a foreign jurisdiction, provided that such plan or family of plans: (1) has, in the aggregate, at least 10,000 participants and beneficiaries and \$10 billion in assets; (2) is operated in a non-discriminatory manner insofar as a wide range of employees, regardless of income or position, are

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<sup>4</sup> See FINRA Rule 5130(i)(10).

<sup>5</sup> 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 FINRA Rule 5131(e)(3).

<sup>6</sup> FINRA Rule 5131(b)(2) provides that all but one of the exempt purchasers in FINRA Rule 5130(c) (including ERISA plans) are also exempt from the New Issue securities sales restrictions in FINRA Rule 5131. Rule 5131 will be conformed so this proposed new exempt purchaser would also be exempt from FINRA Rule 5131.

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eligible to participate without further amendment or action by the plan sponsor; (3) is 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) is not sponsored by a broker-dealer.

### Alternative Conditions for the Foreign Investment Company Exemption

FINRA Rule 5130(c)(6) currently exempts sales to 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. This is intended to exempt foreign investment companies that are similar to U.S. registered investment companies, which are also currently exempt under FINRA Rule 5130(c)(1). FINRA proposes to add the following two alternatives to the five percent test for a foreign investment company to qualify for the exemption: (1) the investment company has 100 or more direct investors; or (2) the investment company has 1,000 or more indirect investors. However, the proposed rule change would also add a new condition to the exemption that the foreign investment company was not formed for the specific purpose of investing in New Issue securities.

### Sovereign Entity Exemption

As described above, Restricted Persons include direct and indirect owners of broker-dealers.<sup>7</sup> FINRA explains that this category is included because the prohibition on purchases of New Issue securities by a broker-dealer could be circumvented if the owners of a broker-dealer were permitted to purchase New Issues securities. FINRA is proposing to exclude sovereign entities<sup>8</sup> from the owners of broker-dealers category of Restricted Person under FINRA Rule 5130(i)(10)(E).

### Exclusion for Foreign Offerings

Currently, the definition of New Issue security could include non-U.S. IPOs if a FINRA member firm or an associated person is participating in the offering or receiving allocations of New Issue securities as an investor. FINRA proposes to exclude Regulation S offerings and other offerings made outside the United States from the definition of New Issue and thus the prohibitions in Rules 5130 and 5131.

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<sup>7</sup> The category includes such owners that are listed, or required to be listed, on Schedules A and B of Form BD (Uniform Application for Broker-Dealer Registration) and that have an ownership interest above specified thresholds.

<sup>8</sup> New defined terms would be added to Rule 5130. "Sovereign entity" for purposes of this Rule would be "a sovereign nation or a pool of capital or an investment fund owned or controlled by a sovereign nation and created for the purpose of making investments on behalf of the sovereign nation," and the term "sovereign nation" would be defined as "a sovereign nation or its political subdivisions, agencies or instrumentalities."

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### Issuer Directed Securities

FINRA Rules 5130 and 5131 both provide an exemption from the New Issue securities sales restrictions for securities sold at the direction of the issuer in certain circumstances. FINRA proposes to amend Rule 5130 to expand the exemption for issuer-directed securities to be more consistent with a similar exemption that is in Rule 5131. Specifically, Rule 5130 would be amended to include allocations directed by affiliates and selling shareholders of the issuer and not just the issuer. The provision would also provide that the exemption applies to shares that are specifically directed in writing by the issuer.

### Charities Excluded from the Definition of “Covered Non-Public Company”

Due to their size, some charitable organizations fall within the definition of a covered non-public company for purposes of FINRA Rule 5131, making executive officers or directors of such organizations subject to the rule’s prohibitions.<sup>9</sup>

FINRA is proposing to amend paragraph (e)(3) of Rule 5131 to exclude unaffiliated charitable organizations, as currently defined in the Rule,<sup>10</sup> 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 FINRA member allocating IPO shares would not become a Covered Person under FINRA Rule 5131 solely on the basis of that position.

### Addition of Anti-Dilution Exemption Provision to FINRA Rule 5131

FINRA Rule 5130 allows Restricted Persons that are existing equity owners of an issuer under certain conditions to purchase shares of the issuer in an initial public offering to be able to maintain their equity ownership position. However, FINRA Rule 5131 does not currently include a similar provision. FINRA proposes to add the exemption to Rule 5131.

### Family Offices as Family Investment Vehicles

As described above, the definition of “Restricted Person” in FINRA Rule 5130 includes portfolio managers. Portfolio managers are defined under FINRA Rule 5130 as persons with the authority to buy or sell securities for, among other entities, a collective investment account. Importantly, a legal entity that is beneficially owned solely by immediate family

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<sup>9</sup> FINRA believes that charitable organizations are not likely to generate significant investment banking business and, thus, there is a low risk, if any, that improper incentives would motivate a FINRA member’s or an associated person’s decision to allocate shares to the account of executive officers or directors of such organizations.

<sup>10</sup> An “unaffiliated charitable organization” is defined in FINRA Rule 5131(e)(9) 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).

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members (“family investment vehicle”) is specifically excluded from the term collective investment account. An immediate family member is defined as 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 and any other individual to whom the person provides “material support.” As a result, a person with authority to buy or sell securities for an account beneficially owned only by immediate family members is not, as a result of such authority, a portfolio manager and thus not a Restricted Person under Rule 5130.<sup>11</sup>

Family offices are entities established by families to manage their wealth and provide other services to family members and are excluded from the definition of “investment adviser” and, thus, are not subject to regulation under the Investment Advisers Act of 1940 (the “Advisers Act”). The Advisers Act defines a “family office” as a company that, among other conditions, is wholly owned by family clients. The term “family client” includes, among other defined persons, “family members” as well as “key employees” of the family office.

Although they overlap in many ways, differences exist between a family investment vehicle under FINRA Rule 5130 and the family office under the Advisers Act. These differences create inconsistencies, which FINRA states do not further the purposes of FINRA Rule 5130 with respect to the treatment of family offices under the two regimes. As described above, the definition of immediate family member under FINRA Rule 5130 includes a specific list of the types of relatives, 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. “Family clients” are defined under the Advisers Act rules to include not only family members but former family members, key employees and other related entities and persons. Since family clients are defined in the Advisers Act and rules to include a larger group of persons than immediate family members under Rule 5130, a family member with authority to buy or sell securities on behalf of a family office for the account of a permitted family client of such family office could be deemed to be a portfolio manager for doing so, and thus a Restricted Person for purposes of FINRA Rule 5130.<sup>12</sup>

FINRA is proposing to expand the definition of “family investment vehicle” under Rule 5130 to also include entities that are beneficially owned solely by “family members” and “family clients,” which are terms used in the family office context and are defined in Advisers Act Rule 202(a)(11)(G), subject to some limitations.

Specifically, the proposed rule change would amend FINRA Rule 5130(i)(4) to define a “family investment vehicle” as a legal entity that is beneficially owned solely by one or more of the following persons: (1) “immediate family members” as currently defined under FINRA Rule 5130(i)(5); (2) “family members” as defined under Advisers Act Rule 202(a)(11)(G)-1; or (3) “family clients” as defined under Advisers Act Rule 202(a)(11)(G)-1. As mentioned above, FINRA has included a

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<sup>11</sup> Such a person may be a Restricted Person for other reasons, for example, if that person is an employee of a broker-dealer.

<sup>12</sup> FINRA provides as an example that having grandchildren or grandparents as beneficial owners of 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 FINRA Rule 5130.

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limitation on its proposed expansion of the exclusion from the definition of portfolio manager. Where the beneficial owners of such an entity include “family clients” that are not “family members,” the persons with authority to buy or sell securities for such an entity may only rely on the exclusion from being portfolio managers, and thus not be Restricted Persons, if they are also “immediate family members” as defined in FINRA Rule 5130(i)(5) or “family members” as defined in Advisers Act Rule 202(a)(11)(G)-1.

### Next Steps

Since these proposed changes will permit FINRA members to sell New Issue securities to additional persons and entities, and allow managers of investment vehicles purchasing New Issues to allocate New Issue profits and losses to such persons who are the beneficial owners of those vehicles, when these proposals are finalized revisions will need to be made to securities markets participants’ procedures concerning sales, purchases or allocations of New Issue securities. Questionnaires and other documents used to determine status of clients or investors as Restricted Persons and Covered Persons will also need to be updated to reflect these changes.

If you have any questions regarding this client alert, please contact the following attorney or the Willkie attorney with whom you regularly work.

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