

CLIENT ALERT

# SEC Approves Amendments to the FINRA New Issue Rules

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## AUTHOR

**Martin R. Miller**

The Securities and Exchange Commission (“SEC”) has approved amendments to Rules 5130 and 5131 of the Financial Industry Regulatory Authority, Inc. (“FINRA”), 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 to otherwise make modifications to address certain issues with the rules in their current form.<sup>2</sup>

FINRA will announce the effective date of the rule changes in a FINRA Regulatory Notice that is expected to be published in the near future. The effective date will be no later than 30 days following publication of that Regulatory Notice.

## 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;

<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> 84 Fed. Reg. 61102 (Nov. 12, 2019). Release No. 34-87470; File No. SR-FINRA-2019-022. Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Partial Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Partial Amendment No.1, 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).

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## SEC Approves Amendments to the FINRA New Issue Rules

(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>3</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>4</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.

### Revised 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>5</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 Issue securities. FINRA is adding a new subsection 5130(c)(8) 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 so a wide range of employees, regardless of income or position, are 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. In response to comments, FINRA is also extending the new

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<sup>3</sup> See FINRA Rule 5130(i)(10).

<sup>4</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>5</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 new exempt purchaser would also be exempt from FINRA Rule 5131.

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## SEC Approves Amendments to the FINRA New Issue Rules

exemption in 5130(c)(8) to employee benefit plans organized in the United States that meet the conditions listed in (1) through (4) above.

### 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 is adding 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 rule change will also add a new condition to the exemption that the foreign investment company was not formed for the specific purpose of permitting restricted persons to invest in New Issue securities.

### Sovereign Entity Exemption

As described above, Restricted Persons include direct and indirect owners of broker-dealers.<sup>6</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 Issue securities. FINRA will exclude sovereign entities<sup>7</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 Rule 5130(i)(9) will exclude Regulation S offerings and other offerings made outside the United States from the definition of New Issue security and thus the prohibitions in Rules 5130 and 5131, but not those offerings that are concurrently registered for sale in the U.S. FINRA will also add supplementary material to both Rules 5130 and 5131 to clarify that the rules are not intended to restrict allocations of New Issue securities to non-U.S. persons by foreign non-FINRA member

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<sup>6</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 the specified thresholds.

<sup>7</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, investment fund, or other vehicle 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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## SEC Approves Amendments to the FINRA New Issue Rules

broker-dealers participating in the underwriting syndicate, provided such allocations are not made at the direction or request of FINRA members or their associated persons.

### Exclusion for SPACs

FINRA is also amending Rule 5130(a)(9) to exclude securities issued by special purpose acquisition companies (“SPACs”) from the definition of New Issue securities.

### 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 will amend Rule 5130 to expand the exemption for issuer-directed securities to be more consistent with a similar exemption that is in Rule 5131 to include allocations directed by affiliates and selling shareholders of the issuer and not just the issuer. Currently, Rule 5130 provides that when issuer directed allocations of New Issue securities are directed to broker-dealer personnel or their immediate family members those allocations are permitted only if recipients are also employees or directors of the issuer, its parent or a subsidiary of the issuer or its parent. Rule 5130(d) will be expanded to allow New Issue securities to be directed to broker-dealer personnel and their immediate family members when such persons are also employees or directors of franchisees of the issuer, its parent or a subsidiary of the issuer or its parent.

### 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>8</sup>

FINRA is amending paragraph (e)(3) of Rule 5131 to exclude unaffiliated charitable organizations, as currently defined in the rule,<sup>9</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.

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<sup>8</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>9</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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## SEC Approves Amendments to the FINRA New Issue Rules

### 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 in order to maintain their equity ownership position. However, FINRA Rule 5131 does not currently include a similar provision. FINRA is adding 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 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>10</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 as defined under Rule 5130, a family member with authority to buy or sell securities on behalf of a family office

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<sup>10</sup> Such a person may be a Restricted Person for other reasons, for example, if that person is an employee of a broker-dealer.

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## SEC Approves Amendments to the FINRA New Issue Rules

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>11</sup>

FINRA is expanding 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).

Specifically, the rule change will 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.

### New Issue Lock-Up Agreements

Current Rule 5131(d)(2) requires that any lock-up agreement applicable to the officers and directors of an issuer entered into in connection with a New Issue security 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 bookrunning 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. The rule provides an exception where the release or waiver is for a transfer that is not for consideration and where the transferee has agreed in writing to be bound by the same lock-up agreement terms in place for the transferor. FINRA is extending the exception to also include transfers to immediate family members as defined in Rule 5130(i)(5), 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, FINRA is codifying prior guidance by amending Rule 5131.03 to provide that the disclosure of a release or waiver in a publicly filed registration statement in connection with a secondary offering satisfies the requirement for an announcement through a major news service.

### Next Steps

Since these changes will change which persons are considered restricted or covered under the rules, permit FINRA members to sell New Issue securities to additional persons and entities, and will allow managers of investment vehicles purchasing New Issue securities to allocate profits and losses from New Issue securities to such persons that are the beneficial owners of those vehicles, revisions will need to be made to securities markets participants' procedures concerning lock-ups, sales, purchases or allocations of New Issue securities. Questionnaires and other documents used

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<sup>11</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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## SEC Approves Amendments to the FINRA New Issue Rules

to determine the 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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**Martin R. Miller**

212 728 8690

[mmiller@willkie.com](mailto:mmiller@willkie.com)

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