

## Investment Management

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# FINRA Amends New Issue Rules 5130 and 5131

***FINRA eases restrictions and harmonizes distribution rules***

By Scott H. Moss, Eileen Overbaugh and Alexander D. Zozos

## What You Need To Know:

- **New Issue Restriction Exemptions have been broadened.**
- **Private funds must update their subscription agreements and annual investor certifications.**

The Financial Industry Regulatory Authority ("FINRA") has amended Rules 5130 and 5131 (together, the "Rules") to help facilitate capital raising and to ease the administrative burden of the new issue<sup>1</sup> distribution restriction. The amended Rules became effective January 1, 2020, and were highlighted as a priority in FINRA's 2020 Risk Monitoring and Examination Priorities Letter.<sup>2</sup> In light of these changes, it is important for private funds that deal in new issues to update their subscription agreements and annual investor certifications, and to update their allocation of new issues to previously restricted investors.

In addition, private funds may take comfort that certain foreign security and special purpose acquisition company ("SPAC") offerings now are explicitly excluded from the Rules' offering restrictions.

### I. Overview of FINRA Rules 5130 and 5131

The Rules, which work in tandem, help ensure the initial public offering process is fair by restricting certain securities from being distributed to

restricted persons who possess an insider status or who could inure a quid pro quo benefit by participating in the distribution (commonly referred to as "spinning"). Restricted individuals under the current Rules include owners and associated persons of a broker-dealer, portfolio managers, as well as executive officers and directors of public companies or covered non-public companies who engage, or could engage, in investment banking business with the broker-dealer involved in the distribution.

### II. Broadening Investor Exemptions

The Rules have been updated to broaden exemptions allowing for the allocation of new issues provided to the following types of investors:

**Sovereign Wealth Funds.** A sovereign wealth fund ("SWF") is a pool of capital or an investment fund owned or controlled by a sovereign nation created for the purpose of making investments on behalf of the sovereign nation. The amended Rules now allow a SWF to either directly or indirectly have an ownership interest in a broker-

<sup>1</sup> New issue means any initial public offering of an equity security as defined in Section 3(a)(11) of the Securities Exchange Act of 1934, as amended.

<sup>2</sup> FINRA's 2020 Risk Monitoring and Examination Letter was published January 9, 2020, and is available here: <https://www.finra.org/rules-guidance/communications-firms/2020-risk-monitoring-and-examination-priorities-letter>.

dealer and be exempt from the new issue distribution restriction.

**Foreign Investment Companies.** A foreign investment company may now use at least one of three qualifying conditions to be exempt from the new issue distribution restriction. A foreign investment company will be exempt from the new issue distribution restriction if it either has: 100 or more direct investors, 1,000 or more indirect investors, or no restricted person owns more than five percent of its shares.

**Employee Benefit Plans.** The amended Rules exempt employee benefit plans (foreign or domestic) from the new issue distribution restriction, contingent on the employee benefit plan having at least 10,000 plan participants, at least \$10 billion in assets, and being operated in a non-discriminatory manner, administered by a trustee or manager that has a fiduciary obligation and is not sponsored by a broker-dealer. This Rules change is intended to harmonize regulatory exemptions.<sup>3</sup>

**Family Offices.** The Rules were amended to broaden the family office exemption to include “family member” and “family client” as defined in the Investment Advisers Act of 1940.<sup>4</sup> This change notably exempts “key employees” such as an unrelated portfolio manager of the family office who previously would have been subject to the new issue distribution restriction.

**Officers and Directors of Charities.** The amended Rules exclude unaffiliated charitable organizations from the definition of “covered non-public company.”<sup>5</sup> This change ensures that officers and directors of charitable organizations (i.e., 501(c)(3) organizations) are exempt from the new issue distribution restriction.

### III. Harmonizing Exemptions

The Rules have been harmonized to provide regulatory consistency in the following instances:

**Issuer-Directed Allocations.** The Rules contained exemptions that differed slightly from the new issue distribution restriction for new

issue allocations that are issuer-directed. The amended Rules harmonize these differences by broadening the exemption included in Rule 5130 to apply to an affiliate of the issuer or a selling shareholder, while also requiring the issuer to make this direction in writing.

**Anti-Dilution Provision.** Rule 5130 contained an anti-dilution exemption to the new issue distribution restriction, whereas Rule 5131 did not. FINRA amended Rule 5131 to include an identical anti-dilution exemption provision that now allows executive officers and directors to maintain their equity holdings subject to the same qualifying conditions prescribed in Rule 5130.

### IV. Limiting Scope

The Rules have been updated to expressly exclude the following type of securities offerings:

**Foreign Offerings.** FINRA has clarified that foreign offerings, such as those conducted pursuant to Regulation S, are not subject to the new issue distribution restriction and therefore, restricted persons may fully participate in such offerings. This exclusion is not available if the Regulation S offering is made concurrently with a domestic offering.

**SPACs.** A SPAC is a publicly traded entity that raises money for the purpose of purchasing an operating business. The money raised is placed into a trust prior to the acquisition of the business. An offering of interests in a SPAC no longer is subject to the new issue distribution restriction, and therefore, restricted persons may fully participate in such offerings.

### V. Takeaways

Private fund managers should:

- Update their subscription agreements to reflect the new exceptions to the Rules.
- Update their annual investor certifications to reflect the new exceptions to the Rules.
- Given the broadened exemptions, reassess whether each of its private funds may now be unrestricted by qualifying for the de

<sup>3</sup> Domestic employee benefit plans subject to the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) were already exempt from the new issue distribution restriction. See FINRA Rule 5130(c)(7). This exemption codifies an exemption request that previously had been granted. See <https://www.finra.org/rules-guidance/guidance/interpretive-letters/amy-hatterson-kroll-morgan-lewis-bockius-ilp-0>.

<sup>4</sup> Rule 202(a)(11)(G)-1 of the Investment Advisers Act of 1940, as amended.

<sup>5</sup> A covered non-public company is a company that satisfies the following criteria: 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; (ii) shareholders’ equity of at least \$30 million and a two-year operating history; or (iii) 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).

minimis exemption for entities in which a limited percentage of new issues profits and losses are held by, or shared with, restricted persons.

- Recalculate the allocation of new issues participation, and the expenses associated with that participation, within their private funds on a go-forward basis.

Please contact one of the listed authors of this Client Alert or another Lowenstein Sandler contact if you have any questions with respect to FINRA Rules 5130 and 5131, or if you would like assistance reviewing and updating your documents or with respect to the applicability of the Rules to a securities offering.

For additional information regarding FINRA Rules 5130 and 5131 amendments, please see below links:

- [FINRA Proposing Release](#)
- [FINRA Amendment](#)
- [SEC Approval Order](#)
- [FINRA Reg. Notice 19-37](#)
- [FINRA 2020 Risk Monitoring and Examination Priorities Letter](#)

## Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

### **SCOTT H. MOSS**

Partner

**T: 646.414.6874**

[smoss@lowenstein.com](mailto:smoss@lowenstein.com)

### **EILEEN OVERBAUGH**

Partner

**T: 212.419.5848**

[eoverbaugh@lowenstein.com](mailto:eoverbaugh@lowenstein.com)

### **ALEXANDER D. ZOZOS**

Associate

**T: 646.414.6868**

[azozos@lowenstein.com](mailto:azozos@lowenstein.com)

NEW YORK

PALO ALTO

NEW JERSEY

UTAH

WASHINGTON, D.C.

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