

FINRA Amendments to the Anti-Spinning Rules

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FINRA Amendments to Rules 5130 and 5131

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently effected changes to its rules regarding the purchase, sale, allocation, and distribution of initial equity public offerings, or "new issues." FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) and Rule 5131 (New Issue Allocations and Distributions) (together, the "Rules") were amended to "enhance regulatory consistency and address unintended operational impediments."^[1] Together, the Rules are intended to protect the integrity of public offerings by restricting the sale, allocation, and distribution of certain new issues to "Restricted Persons." The recently adopted amendments attempt to clarify and harmonize the regulations regarding new issues and expand the exemptions to the definition of "Restricted Person," thereby effectively reducing the number of individuals and entities that would have otherwise been classified as Restricted Persons.

Background of 5130 and 5131

The Rules predominately work to prevent sales, allocations, and distributions of new issues to Restricted Persons and those other persons whom FINRA believes create the largest threat of unfair offerings. Generally, the term "Restricted Person" includes broker-dealers, owners and employees of broker-dealers, and portfolio managers, as well as executive officers and directors of public and certain non-public companies. In effect, the Rules work together to create a more fair initial equity offering environment by: (i) requiring FINRA members to make bona fide public offerings of new issues at the offering price; (ii) prohibiting FINRA members from withholding new issues for their own benefit; (iii) prohibiting industry insiders from taking advantage of their positions with respect to new issues at the expense of other investors; and (iv) prohibiting broker-dealers from allocating new issues for the purpose of attracting prospective investment banking clients (a tactic known as "spinning").

The New "Restricted Person" Exemptions

The update to the Rules broadens the exemptions to the definition of a "Restricted Person" to allow the following types of investors to participate in offerings of new issues:

- **Foreign Investment Companies.** Investment Companies organized under the laws of a foreign jurisdiction were previously exempted from Restricted Person status only (1) if the company was listed on a foreign, public, and regulated exchange and (2) if no other Restricted Person owned more than 5% of the Company's shares, which is difficult for a company to know when its shares are held in an omnibus account or in nominee form. In order to lessen that burden, the Rules now provide an alternative exemption (in addition to the exemption set forth in the prior sentence) for Foreign Investment Companies who (1) have 100 or more direct investors or (2) have 1,000 or more indirect investors, so long as the investment company was not formed for the specific purpose of investing in the new issue.
- **Sovereign Entities (or "Sovereign Wealth Funds").** The Rules, as amended, exclude from Restricted Person status Sovereign Entities that hold ownership interests in broker-dealers. The term "Sovereign Entities" includes (1) Sovereign Nations and (2) pools of capital, investment funds, and other investment vehicles that invest on behalf of and for the benefit of Sovereign Nations. The term "Sovereign Nation," as used in the Rules, means "a sovereign nation or its political subdivisions, agencies or instrumentalities." A Sovereign Entity's related persons and affiliates are still considered Restricted Persons if they are otherwise included in the definition of a "Restricted Person," as is the broker-dealer in which the Sovereign Entity owns an interest. The amendments to the Rules only exclude the Sovereign Entity.
- **Employee Retirement Benefit Plans.** The amendments to the Rules provide a general exemption for U.S. and non-U.S. employee retirement benefit plans, provided that the plans meet certain conditions. The plan or the family of plans must (1) have, in aggregate, 10,000 participants and beneficiaries and \$10 billion in assets; (2) be

operated in a non-discriminatory manner;^[2] (3) be administered by trustees or managers with a fiduciary relationship to the employees and their beneficiaries; and (4) not be solely sponsored by a broker-dealer.

- **Family Investment Vehicles.** A person with investment authority for a Family Investment Vehicle is not considered a Restricted Person solely based on his or her management of that Family Investment Vehicle. The amended Rules align the definition of “Family Investment Vehicle” with the Family Office Rule under the Investment Advisers Act of 1940. Now, for purposes of the Rules, a Family Investment Vehicle is a legal entity beneficially owned solely by any combination of “immediate family members” (as defined in Rule 5130), “family members” (as defined under Family Office Rule), and “family clients” (as defined under the Family Office Rule).
- **Officers and Directors of Unaffiliated Charitable Organizations.** Officers and directors of covered non-public companies are Restricted Persons based on the anti-spinning provisions of Rule 5131. The past definition of “covered non-public companies” unintentionally included charitable organizations. Because there is a low risk of charitable organizations spinning business back to broker-dealers after an allocation to their officers and directors, the Rule now excludes “Unaffiliated Charitable Organizations”^[3] from the list of Restricted Persons. Therefore, an officer or director of an Unaffiliated Charitable Organization who is not affiliated with the broker that is allocating shares in the new issue is not prevented from receiving the shares based on Rule 5131.

Other Changes Made to Clarify or Harmonize Regulations

The following changes were made to either clarify or harmonize the overall regulatory regime of Rules 5130 and 5131:

- **Issuer-Directed Allocations.** Rules 5130 and 5131 both include exemptions for allocations of new issues made by the issuer as long as the FINRA member or broker-dealer has no influence regarding the particular allocation. The amendments clarify that the exemption extends to allocations of new issues made by one or more of the issuer’s affiliates or selling shareholders. Further, the exemption applies to allocations of new issues to those who would otherwise be Restricted Persons if they are employees or directors of the issuer, the issuer’s parent, its subsidiary or its affiliate. The amendment extends this exemption to the issuer’s franchisees. Finally, the Rules now require that the issuer-directed allocation be done in writing.
- **Anti-Dilution of a Restricted Person’s Shares.** Under Rule 5130, Restricted Persons who have held an equity ownership for one year may purchase shares offered in a new issue to prevent dilution of their current position. They may do so as long as the new purchase does not increase their stake in the issuer, their new purchase does not contain specialized terms, and the Restricted Person complies with a three-month lock-up period. The amended Rule 5131 now contains a similar anti-dilution provision that allows restricted directors and officers to maintain their equity holdings in an issuer.

Securities Offerings Specifically Excluded From the Definition of “New Issues” and Rules 5130 and 5131

FINRA expressly excluded the following types of securities offerings from the types of offerings subject to Rules 5130 and 5131:

- **Foreign Offerings.** Foreign Offerings made under Regulation S of the Securities Act of 1933 and other public offerings made outside of the U.S. or its territories are now expressly excluded from the types of offerings regulated by the Rules. These offerings will be excluded as long as the securities are not concurrently registered for sale in the United States.
- **Special Purpose Acquisition Companies (“SPACs”).** SPACs are publically held companies that raise capital through public markets for the purpose of purchasing another operating entity. Because the only asset SPACs initially have is the money raised in the public offering, there is usually little to no premium realized in the stock price after the public offering. The amendments exclude offerings of SPACs from Rules 5130 and 5131 regulation. Therefore, Restricted Persons can participate fully in new SPAC issuances.

The following types of securities offerings were already excluded from the definition of “New Issue” and continue to be exempt from the Rules’ prohibitions:

- **Offerings of securities of a commodity pool operated by a commodity pool operator;**
- **Rights offerings and other types of offerings made pursuant to a merger or acquisition;**
- **Offerings of investment grade asset-backed securities;**
- **Offerings of convertible securities;**

- Offerings of preferred securities;
- Offerings of an investment company registered under the Investment Company Act;
- Certain offerings of Securities that have a pre-existing market outside of the United States; and
- Offerings of Securities in closed-end investment companies with little chance of an immediate post-offering premium (similar to SPACs), including:
 - Business Development Companies;
 - Direct Participation Programs; and
 - Real Estate Investment Trusts.

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[1] See Securities Exchange Act Release No. 87,470, 84 Fed. Reg. 61,102 (November 5, 2019) (Granting Accelerated Approval of File No. SR-FINRA-2019-022).

[2] Meaning, a wide range of employees are eligible and the employees are not eligible simply based on income or position. If the employee, because of his or her income or position, is eligible only after further action or amendment by the sponsor, then the plan will not meet this requirement.

[3] An "Unaffiliated Charitable Organization" is a tax-exempt entity organized under Section 501(c)(3) of the Internal Revenue Code (1) that is not affiliated with the FINRA-member firm and (2) for which no executive officer or director of the FINRA-member firm (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 (those individuals include officers, directors, trustees, key employees, highest compensated employees, and certain independent contractors). See Securities Exchange Act Release No. 87,470, 84 Fed. Reg. 61,102, 61,104 (November 5, 2019) (Granting Accelerated Approval of File No. SR-FINRA-2019-022).