

FINRA PROPOSES AMENDMENTS TO ITS "NEW ISSUE" RULES WITH KEY IMPLICATIONS FOR FOREIGN FUND MANAGERS AND INVESTORS

In July of this year, the United States Financial Industry Regulatory Authority ("FINRA") issued proposed amendments (the "**Proposed Amendments**") to FINRA Rules 5130 and 5131 (the "**New Issue Rules**") that, if adopted, would provide much needed clarity for certain fund managers and investors that participate in initial public offerings ("**IPOs**") of equity securities ("**New Issues**").¹ The Proposed Amendments seek to promote capital formation by, among other things, making it easier for certain investors to participate in New Issues, and reducing the regulatory burdens associated with compliance with the New Issue Rules. While the Proposed Amendments would benefit fund managers and investors generally, they contain provisions of particular importance to non-US fund managers and investors.

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Background

FINRA adopted the New Issue Rules to help prevent industry insiders (e.g., broker-dealers, portfolio managers, etc.) from profiting at the expense of non-insiders through *quid pro quo* arrangements in which the insiders receive New Issues from FINRA members in exchange for directing trading or other business to the FINRA firm. FINRA Rule 5130 generally prohibits FINRA members (i.e., SEC-registered broker-dealers) and their associated persons from, among other things, distributing New Issues to "accounts" in which certain industry insiders, including broker-dealers, portfolio managers, banks, and the other persons set out in the rule (collectively, "**Restricted Persons**") have a beneficial interest. FINRA interprets this prohibition to apply to allocations to collective investment vehicles (e.g., hedge funds) in which Restricted Persons have a substantial interest. FINRA Rule 5131 imposes a similar prohibition on the allocation of New Issues to

¹ 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); SEC Release 34-86558, 84 Fed. Reg. 39,029 (Aug. 8, 2019).

"accounts" of executive officers, directors, and others associated with prospective and existing investment banking clients ("**Prohibited Persons**").

There are exceptions to these prohibitions. FINRA Rule 5130 and Rule 5131 each permit accounts to receive New Issues if the profits and losses that are allocated to Restricted Persons or Prohibited Persons do not exceed certain *de minimis* thresholds. Rule 5130 permits Restricted Persons to participate in 10% or less of the profits or losses attributable to New Issues, while Rule 5131 permits Prohibited Persons to participate in 25% or less of the profits or losses attributable to New Issues.

In order to stay within the *de minimis* limitations, investment advisers to hedge funds and other investment vehicles must: (i) identify the Restricted Persons and Prohibited Persons that are invested in the funds managed by the adviser (through lengthy questionnaires in fund subscription documents); (ii) regularly monitor and update ownership percentages of fund investors; and (iii) if necessary, "carve-out" Restricted Persons and Prohibited Persons from, and/or limit their participation in, New Issues.

Key Proposed Amendments For Non-US Managers

The New Issue Rules do not currently distinguish between US and non-US offerings, which has led to questions about their application to offshore offerings. Similarly, much of the interpretive guidance exempting certain investors from the New Issue Rules does not clearly apply to non-US persons. The Proposed Amendments break this historical mold and offer the following relief to non-US fund managers and investors:

1. **Exclusion of Foreign Offerings.** The current definition of New Issues is not expressly limited to US-listed New Issues, resulting in some FINRA member firms classifying non-US offerings as being subject to the New Issue Rules. The Proposed Amendments exclude from the New Issue Rules *all* offerings made outside the US and its territories, including those listed on non-US exchanges. Under the proposal, investment advisers would no longer need to limit the participation of Restricted Persons and/or Prohibited Persons in the profits and losses attributable to non-US IPOs. The proposed amendments would also permit investment advisers who limit their IPO investments solely to non-US offerings to omit lengthy New Issue Rule questionnaires from their subscription documents.
2. **Foreign Employee Retirement Benefit Plans.** Employee retirement benefit plans may have thousands of participants and beneficiaries, and may thus be unable to determine if persons with a beneficial interest in the plan are Restricted Persons. FINRA Rule 5130 explicitly exempts certain US retirement plans from the Restricted Person definition, and FINRA has issued interpretive guidance exempting certain non-US plans where, in FINRA's view, the non-US plan could not "serve as a conduit for restricted persons to purchase new issues."² The Proposed Amendments would codify this historical guidance.

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² The exemptive relief focuses on the number of investors in a plan and the fact that it is administered by trustees and managers with fiduciary obligations to administer the plan in the best interests of participants and beneficiaries. See, e.g., Letter from Gary L. Goldsholle, FINRA, to

3. **Foreign Investment Companies.** Currently, FINRA exempts sales of New Issues to non-US investment companies from Rule 5130's prohibitions if:
(i) the non-US investment company is publicly offered on a non-US exchange or authorized for sale to the public by a non-US regulatory authority; and (ii) no Restricted Person owns more than 5% of the shares of the investment company. In practice, the 5% ownership limitation has often been impractical to administer, as the non-US investment company's shares are purchased through intermediaries that carry the securities in their name, making it difficult to determine ultimate beneficial ownership. The Proposed Amendments provide an alternative for such non-US investment companies by specifically excluding them from the provisions of Rule 5130 if they have at least 100 direct owners or 1,000 indirect owners, and were not formed for the specific purpose of investing in New Issues.
4. **Exemption for Sovereign Wealth Funds & Other Entities.** The Proposed Amendments also seek to address the inadvertent application of FINRA Rule 5130 to certain sovereign entities, by exempting a sovereign entity that directly or indirectly owns an SEC-registered broker-dealer from the definition of a Restricted Person. While narrowly tailored, this exemption is designed to prevent situations where a sovereign entity does not invest in an SEC-registered broker-dealer, or in a fund holding a financial services company that owns a broker-dealer, to avoid Restricted Person status.

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Delay of the Proposed Amendments

The comment period for the Proposed Amendments ended on August 29, 2019, with final rule amendments expected to be published shortly thereafter. However, FINRA recently filed a letter with the SEC, which provides the SEC until November 6, 2019 to consider the Proposed Amendments.³ Such delays are not uncommon; however, it may suggest that the SEC is closely scrutinizing aspects of what appear to be straightforward proposals.

Conclusion

The Proposed Amendments would provide much needed clarification to fund managers and investors who participate in New Issues, with such amendments being particularly important to non-US-based hedge fund managers.

Edward A. Kwalwasser, Proskauer Rose LLP (Dec. 7, 2010); Letter from Afshin Atabaki, FINRA, to Christopher M. Wells, Proskauer Rose LLP (Nov. 2, 2012); Letter from Meredith Cordisco, FINRA, to Amy Natterson Kroll, Morgan, Lewis & Bockius LLP (July 23, 2015); Letter from Meredith Cordisco, FINRA, to Amy Natterson Kroll, Morgan, Lewis & Bockius LLP (Apr. 16, 2018).

³ See Letter Re: File No. 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) from Afshin Atabaki to Joan M. Collopy (Sept. 10, 2019).

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