To Our Clients and Friends

Memorandum

SEC Approves Amendments to FINRA Rules 5130 and 5131

On November 5, 2019, the Securities and Exchange Commission (the "SEC") approved amendments to FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) and FINRA Rule 5131 (New Issue Allocations and Distributions).[1] FINRA Rule 5130 generally restricts, among other things, broker-dealers (or persons associated with them) from selling shares of a new issue to an account in which a restricted person has a beneficial interest. FINRA Rule 5131 addresses abuses in the allocation and distribution of new issues. Among other things, the rule prohibits the practice of "spinning," which is the allocation of new issues by a firm to executive officers and directors of the firm's current, former or prospective investment banking clients. The SEC-approved amendments to the rules exempt additional persons and offerings from the scope of the rules, modify current exemptions to enhance regulatory consistency, and address unintended operational impediments. The amendments are discussed at a high level below.

Expansion of General Exemptions

1. Foreign Investment Companies. Rule 5130 currently includes an exemption for foreign investment companies that meet certain conditions including, among other things, that no person owning more than 5% of the foreign investment company's shares is a restricted person. The amendments to Rule 5130 provide two alternatives to that condition: (a) the foreign investment company has 100 or more direct investors or (b) the foreign investment company has 1,000 or more indirect investors. A foreign investment company relying on this amended exemption cannot have been formed for the specific purpose of permitting restricted persons to invest in new issues. A corresponding exemption is available under amended Rule 5131.

2. Employee Retirement Benefits Plans. The amendments to Rule 5130 add a new exemption from Rule 5130 for U.S. and non-U.S. employee retirement benefits plans that (a) have at least 10,000 plan participants and beneficiaries and $10 billion in assets, (b) are operated in a non-discriminatory manner to allow a wide range of employees to be eligible to participate in the plan, (c) are administered by trustees or managers that have a fiduciary obligation to administer the

[1] 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), Release No. 34-87470 (Nov. 5, 2019).

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funds in the best interests of the participants and beneficiaries, and (d) are not sponsored solely by a broker-dealer. A corresponding exemption is available under amended Rule 5131.

Revisions to Defined Terms

1. Family Investment Vehicle. Portfolio managers of family investment vehicles (which is defined to mean a legal entity that is beneficially owned solely by immediate family members) are excluded from the definition of restricted person under Rule 5130. The amendments to Rule 5130 expand the definition of "family investment vehicle" to include investment vehicles that are beneficially owned by "family members" and "family clients," in each case as defined in Rule 202(a)(11)(G)-1 of the Investment Advisers Act of 1940.[2] As a result, a broader group of portfolio managers of family investment vehicles are no longer treated as restricted persons under amended Rule 5130.

2. New Issue. The amendments to Rule 5130 exclude from the definition of new issue (a) offerings of special purpose acquisition companies and (b) offerings made under Regulation S of the Securities Act of 1933 (the "Securities Act") or otherwise made outside of the United States or its territories. However, the exclusion for foreign offerings would not be available if the securities being offered and sold in the foreign offering are also registered for sale in the United States under the Securities Act in connection with a concurrent initial public offering of an equity security in the United States.

3. Restricted Person. The amendments to Rule 5130 exclude sovereign entities that own a broker-dealer from the definition of restricted person. "Sovereign entity" is defined in Rule 5130, as amended, to mean a sovereign nation or a pool of capital or an investment fund or other vehicle owned or controlled by a sovereign nation and created for the purpose of making investments on behalf or for the benefit of the sovereign nation. "Sovereign nation" is defined to mean a sovereign nation or its political subdivisions, agencies or instrumentalities.

4. Covered Non-Public Company. The amendments to Rule 5131 exclude unaffiliated charitable organizations from the definition of covered non-public company. As a result of this amendment, a person serving as executive officer or director of a charitable organization that is not affiliated with the FINRA member allocating shares in an initial public offering would not become subject to the rule's spinning provision solely on the basis of that service.

Additional Changes

1. Issuer-Directed Securities. The amendments to Rule 5130 expand the exemption for issuer-directed securities to allocations directed by an affiliate of the issuer or a selling shareholder. The amendments to Rule 5130 also require all directed allocations of securities to be in writing.

2. Foreign Non-Member Broker-Dealers Participating in an Underwriting Syndicate. The amendments add Supplementary Material .01 to Rule 5130 and Supplementary Material .05 to Rule 5131 to clarify that foreign non-member broker-dealers participating in an underwriting syndicate are permitted to allocate new issue securities to a non-U.S. person notwithstanding (a)

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[2] This would include, for example, investment vehicles in which non-immediate family members and key employees of a family office are investors.

the prohibitions on the purchase and sale of new issues under amended Rule 5130 and (b) the prohibitions on spinning in paragraph (b) of amended Rule 5131. To be eligible for the exclusion under the Supplementary Material to either Rule, the allocation decision cannot be made at the direction or request of a FINRA member or associated person of a FINRA member.

3. Lock-Up Agreements. Rule 5131 currently requires lock-up agreements with officers and directors of the issuer entered into in connection with a new issue to include a provision requiring a public announcement at least two business days before the release or waiver of the lock-up, subject to certain exceptions. The amendments to Rule 5131 (a) extend the exception from the public announcement requirement to transfers to immediate family members and (b) codify existing guidance stating that disclosures in a publicly filed registration statement in connection with a secondary offering satisfy the public announcement requirement.

4. Anti-Dilution Provisions. The amendments to Rule 5131 include the addition of Supplementary Material .04, which contains anti-dilution provisions similar to those currently included in Rule 5130. Supplementary Material .04 provides that the prohibitions on spinning in paragraph (b) of Rule 5131 do not apply to an account in which an executive officer or director of a public company or a covered non-public company has a beneficial interest, provided that the account retains the percentage equity ownership in the issuer at a level up to the ownership interest as of three months prior to the filing of the registration statement and meets certain other specified conditions.

Next Steps

FINRA has not yet announced the effective date of the amendments. However, in anticipation of that announcement, firms should prepare to update their FINRA Rule 5130 and 5131 questionnaires and/or subscription agreements to incorporate the changes resulting from the amendments.

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Authors:

Jessica Forbes

Stacey Song

Joanna Rosenberg

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

Contacts:

London		
Gregg Beechey	+44.20.7972.9172	gregg.beechey@friedfrank.com
David Christmas	+44.20.7972.9222	david.christmas@friedfrank.com
Kate Downey	+44.20.7972.6221	kate.downey@friedfrank.com
Mark Mifsud	+44.20.7972.9155	mark.mifsud@friedfrank.com
Sam Wilson	+44.20.7972.9223	sam.wilson@friedfrank.com
New York		
Jonathan S. Adler	+1.212.859.8662	jonathan.adler@friedfrank.com
Lawrence N. Barshay	+1.212.859.8551	lawrence.barshay@friedfrank.com
Jeremy R. Berry	+1.212.859.8796	jeremy.berry@friedfrank.com
Gerald H. Brown, Jr.	+1.212.859.8825	gerald.brown@friedfrank.com
Jessica Forbes	+1.212.859.8558	jessica.forbes@friedfrank.com
Jonathan H. Hofer	+1.212.859.8583	jonathan.hofer@friedfrank.com
Bryan Hunkele	+1.212.859.8251	bryan.hunkele@friedfrank.com
Darren A. Littlejohn	+1.212.859.8933	darren.littlejohn@friedfrank.com
Robert M. McLaughlin	+1.212.859.8963	robert.mclaughlin@friedfrank.com
Todd J. McMullan	+1.212.859.8190	todd.mcmullan@friedfrank.com
David S. Mitchell	+1.212.859.8292	david.mitchell@friedfrank.com
Kenneth I. Rosh	+1.212.859.8535	kenneth.rosh@friedfrank.com
Lisa M. Schneider	+1.212.859.8784	lisa.schneider@friedfrank.com
Stacey Song	+1.212.859.8898	stacey.song@friedfrank.com
Washington, D.C.		
Richard I. Ansbacher	+1.202.639.7065	richard.ansbacher@friedfrank.com
William J. Breslin	+1.202.639.7051	william.breslin@friedfrank.com
Matthew W. Howard	+1.202.639.7494	matthew.howard@friedfrank.com
Walid Khuri	+1.202.639.7013	walid.khuri@friedfrank.com
Bradford R. Lucas	+1.202.639.7483	brad.lucas@friedfrank.com
Andrew P. Varney	+1.202.639.7032	andrew.varney@friedfrank.com
Rebecca N. Zelenka	+1.202.639.7260	rebecca.zelenka@friedfrank.com