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# FINRA RULES 5130 AND 5131

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# Overview

- Overview
- Rule 5130
- Rule 5131
- Amendments to the General Exemptions
- Amendments to the Definition of “New Issue”
- Additional Amendments
- Key Takeaways

# Overview – The Rules

- Rules 5130 and 5131 (the “Rules”) promote fairness in the allocation of new issues of equity securities.
- Rule 5130 prevents broker-dealers and portfolio managers from receiving shares of equity securities in IPOs (“new issues”).
- Rule 5131 prevents broker-dealers from allocating new issues to individuals who have the authority or ability to direct their company’s investment banking business to the broker-dealer making the allocation.
- Technically, the Rules apply only to broker-dealers, but they impact the operations of other types of firms, including fund managers, that must make representations to broker-dealers as to the nature of their investors in order to receive new issue allocations.

# Overview – The Amendments

- Amendments to Rules 5130 and 5131 clarify and liberalize the Rules by broadening the Rules' exclusions and exemptions.
- Effective Date: **January 1, 2020**

# Rule 5130

- Prohibits allocations of new issues to accounts of Restricted Persons:
  - broker-dealers,
  - persons who own or control broker-dealers,
  - portfolio managers,
  - Others.
- Exemptions and exclusions recognize that some entities and offerings do not implicate new issue allocation concerns.
- Applies to all securities offerings that are defined as new issues, with limited exceptions.
- Contains a de minimis threshold for restricted persons.
- Permits annual attestation by negative consent.

# Rule 5131

- Prohibits quid pro quo allocations of new issues in exchange for excessive compensation.
- Prohibits allocation of new issue securities to “covered persons”, who are those in a position to direct hiring of broker-dealers for investment banking services.
  - Covered Persons include executive officers or directors of public companies and covered non-public companies – e.g., the prospective investment banking clients.
- Limits flipping of new issue securities and prescribes certain pricing and trading practices for new issues.
- Incorporates the general exemptions of Rule 5130 (with a different de minimis threshold).
  - Therefore, amendments to the general exemptions apply to both Rules 5130 and 5131.

# Amendments to Rules 5130 & 5131 – New General Exemption for Retirement Benefits Plans

- Retirement Plans – The Rules now include a general exemption for accounts of retirement plans or family of plans, whether organized under US or non-US law that:
  - have, in aggregate, at least 10,000 plan participants and beneficiaries and \$10 billion in assets;
  - are operated in a non-discriminatory manner insofar as a wide range of employees, regardless of income or position, are eligible to participate without further amendment or action by the plan sponsor;
  - are administered by trustees or managers that have a fiduciary obligation to administer the funds in the best interests of the participants and beneficiaries; and
  - are not sponsored solely by a broker-dealer.
- Plans that do not qualify under the new general exemption may still seek exemptive relief on a case-by-case basis.

# Amendments to Rules 5130 & 5131 – Amended General Exemption for Foreign Investment Companies

- Foreign investment companies – The amendments expand the general exemption for accounts of investment companies organized under the laws of a foreign jurisdiction.
  - Previously, a foreign investment company's account was exempt from Rule 5130 only if (1) it was listed on a foreign exchange or authorized for sale to the public in a foreign country and (2) No Restricted Person owns no more than 5% of the foreign investment company.
  - The amendments provide two alternatives to the 5% Restricted Person ownership limitation. The exemption would be available to a foreign investment company with at least:
    - 100 direct investors, or
    - 1,000 indirect investors.
  - The amendments also require that the foreign investment company was not formed for the specific purpose of permitting Restricted Persons to invest in new issues.



# Amendments to Rules 5130 – New Exclusion for Sovereign Entities

- Sovereign entities that own broker-dealers were previously Restricted Persons if they had a voting or other equity ownership stake in a broker-dealer that required disclosure on SEC Form BD (generally 10% or more of direct ownership or 25% or more of indirect ownership).
- The amendments exclude sovereign entities from the definition of Restricted Person.
- The amendments have the effect of permitting accounts of sovereign entities to receive new issue allocations even if the sovereign entity has an ownership stake in a broker-dealer over the thresholds for disclosure.
- The amendments define “sovereign entity” as:
  - 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.

# Amendments to Rules 5130 – Expanded Definition of “Family Investment Vehicle”

- Portfolio managers of collective investment accounts are Restricted Persons, with limited exceptions.
- Portfolio managers to family investment vehicles (“family offices”) are not Restricted Persons.
  - Prior to the amendments to Rule 5130 the definition of “family investment vehicle” in Rule 5130 was narrower than the definition in the Investment Advisers Act.
  - This resulted in some family offices being Restricted Persons.
- Rule 5130 has been amended to expand the definition of “family investment vehicle” so that it is consistent with the concept of family office found in the Advisers Act.
  - Specifically, “family investment vehicles” for purposes of Rule 5130 now include those that invest on behalf of multiple generations and also those that include as beneficiaries key employees, including advisers from the family office, even though not family members.

# Amendments to Rules 5131 – Unaffiliated Charitable Organizations

- The definition of “covered non-public company” was amended to exclude “unaffiliated charitable organizations.”
- This change removes from Covered Persons executive officers and directors of unaffiliated charitable organizations.

# Amendments to Definition of “New Issue”: Exclusions for Foreign Offerings of Securities, SPAC

## – Foreign Offerings

- The amendments add an exclusion from the definition of “new issues” for securities offered pursuant to Regulation S of the Securities Act (“Reg S”) or otherwise offered outside the U.S.
- **Note:** The exclusion does not apply to Reg S offerings of securities that also are registered and concurrently offered as new issues in the U.S. unless offered outside the US by a non-US broker/bank that is a member of the selling syndicate in its own right.

## – SPACs

- The amendments add special purpose acquisition companies (“SPACs”) to the list of products excluded from the definition of “new issue.” The Rules already excluded business development companies, direct participation programs and real estate investment trusts, among other securities.

# Additional Amendments

- **Anti-Dilution Provisions (Rule 5131)** – FINRA added supplemental materials to Rule 5131 to add anti-dilution provisions (similar to those already in Rule 5130) to permit the allocation of new issues to Covered Persons in order for them to maintain the percentage of equity ownership they held before the IPO.
  - Both Rule 5130 and Rule 5131 include conditions for reliance on the anti-dilution provisions.
- **Issuer Directed Securities** – The definition of “issuer-directed securities” was harmonized in the Rules by amending Rule 5130 to make this provision consistent with Rule 5131 to exempt from the Rule’s prohibitions allocations directed by affiliated and selling shareholders.

# Key Takeaways

- The Amendments expand the universe of eligible recipients of allocations of new issue securities.
- Offerings made pursuant to Reg S (and not concurrently offered in the U.S.) are expressly excluded from “new issue”.
- Firms will need to update their information in order to maximize the availability of exclusions and exemptions under the amendments:
  - Broker-dealers will need to amend their account opening documents.
  - Investment advisers will need to update investor questionnaires and advisory agreements.
  - Private fund sponsors will also need to update their subscription documents.
- Firms should consider outreach to current investors that are Restricted Persons or Covered Persons to determine if the investors are now eligible to receive new issue allocations.

# ATTORNEY BIOGRAPHIES

# Amy Natterson Kroll



Amy Natterson Kroll counsels US and non-US financial institutions on US regulatory requirements and best practices related to broker and dealer activities. Clients seek Amy's advice on, among other things, issues related to implementation of new regulations; the acquisition and sale of broker-dealers; expansion of business and related regulatory requirements for financial institutions; and regulations related to the capital markets, such as research activities and research analysts, supervisory controls and internal controls, and cross-border securities activities. Amy also advises clients on the collateral consequences of enforcement, civil, and criminal actions. She has a specific interest in the issues central to regional full-service and mid-market broker-dealers.

Amy worked at the Securities and Exchange Commission twice. From 1997–1998 she was assistant general counsel (legislative and financial services) at the SEC, to which she had returned after five years in private practice counseling broker-dealers and other financial institutions. From 1984–1991, during her first tour of SEC service, she served in positions of increasing responsibility, first as an attorney-adviser in the division of Market Regulation (now the division of Trading & Markets), and subsequently as counsel to Commissioner Edward H. Fleischman and as senior special counsel in the division of Corporation Finance, Office of International Corporate Finance.

From 1998–2003, Amy was an independent consultant, focusing on issues confronted by non-US financial entities seeking to engage in broker-dealer activities in the United States. During that time, she also taught at the Washington College of Law, American University.

Amy serves as the Washington office practice group leader for the firm's investment management practice and also is the Washington office hiring partner. She previously served as a member of the NASDAQ Market Operations Committee. Prior to joining Morgan Lewis, Amy was a partner in the financial institutions regulatory, enforcement, and litigation practice at another international law firm.

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Jedd H. Wider focuses on global private investment funds and managed accounts, particularly global hedge, private equity, secondary, and venture capital funds. As co-leader of the global hedge funds practice, he represents leading financial institutions, fund managers, and institutional investors in their roles as fund sponsors, placement agents, and investment entities. He assists clients through all stages of product development and capital raising as well as customized arrangements, seed and lead investor arrangements, and joint ventures. He specializes in all aspects of secondary transactions, and complex financial structurings.

Jedd concentrates on all aspects of bespoke fund products and arrangements including funds of one and managed accounts and regularly advises clients on all aspects of regulatory compliance.

Members of the international media often seek out Jedd for his views on the hedge fund and private equity fund industries and capital markets. His analysis can be found in US and international publications, including *The Wall Street Journal*, *The Economist*, and *Financial Times*, as well as on television networks such as Bloomberg and CNN.

Jedd lectures and serves as a panelist on private investment fund topics for trade programs and organizations around the world. He has delivered speeches and presentations to numerous private fund conferences such as the Hedge Fund Institutional Forum, Dow Jones Private Equity Analyst Limited Partners Summit, Endowments & Foundations Roundtable, Association of Life Insurance Counsel, National Association of Public Pension Fund Attorneys (NAPPA), West Legalworks, InfoVest21 Hedge Fund Conference, the Annual Euromoney Summit of European Hedge Funds in London, Capital Roundtable Fund Conferences, the Annual International Conference on Private Investment Funds in London, the Wharton Private Equity and Venture Capital Conference, the On Point Investors and Hedge Fund Risk Summit, and the Lazard Capital Markets Hedge Fund Conference.

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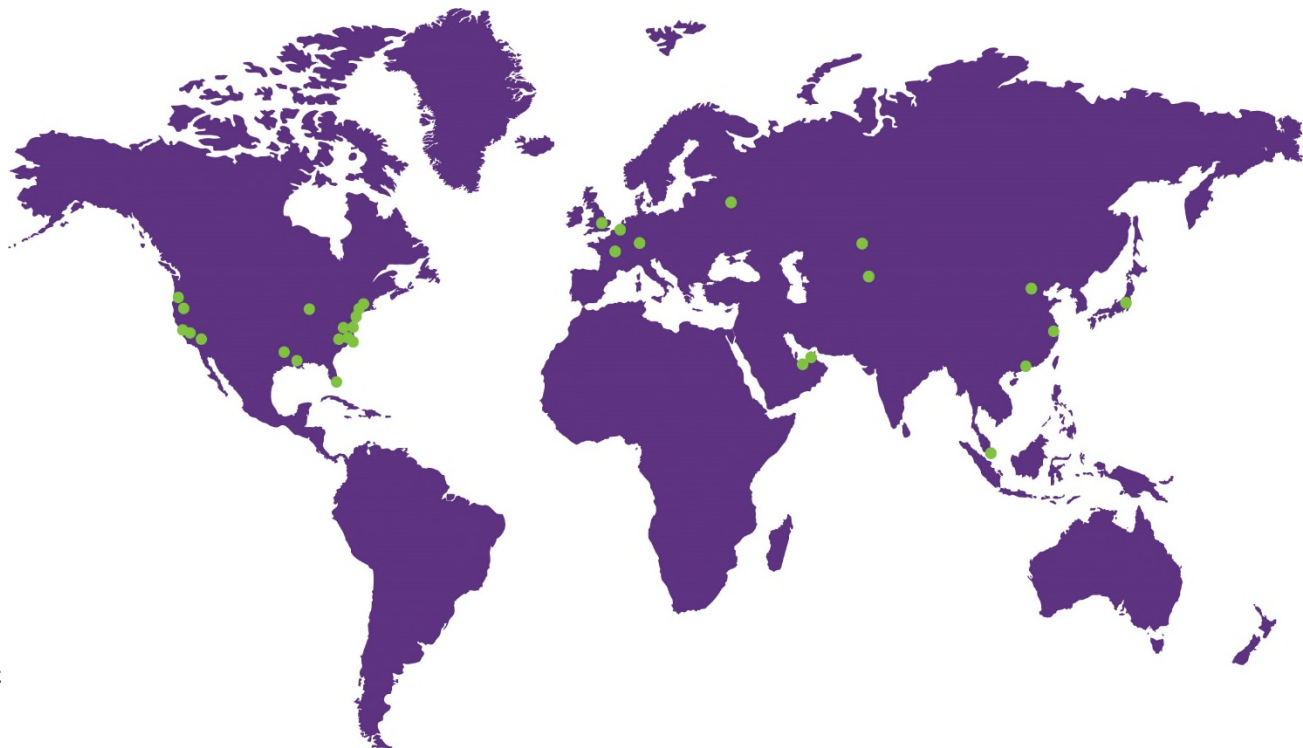
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