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FINRA Corporate Financing

FINRA Solicits Comments on Proposed Amendments to the Corporate Financing Rule (Underwriting Terms and Arrangements)

SUMMARY

FINRA is soliciting comments on proposed amendments to FINRA Rule 5110 – the Corporate Financing Rule – which prohibits FINRA members from participating in public offerings with unreasonable underwriting compensation and terms. The proposal is a complete revision of the rule, makes some substantive changes, clarifies some existing guidance and interpretations and revises the format of the rule. The proposed changes include:

- excluding from the rule's lock-up requirement securities of an issuer that meets the registration requirements of Forms S-3, F-3 or F-10, and securities that are exempt from, or do not meet the definition of, underwriting compensation;
- exempting from the definition of "underwriting compensation" certain securities received to prevent dilution and purchases of securities based on prior investment history;
- designing a single definition of "underwriting compensation" and relocating the current lists of examples of what is and is not underwriting compensation to the Supplemental Material;
- clarifying certain existing guidance and interpretations, including expressly noting that offerings under Rule 144A or Regulation S are not subject to the rule's substantive or filing requirements;
- excluding from the rule's reach entirely public offerings of insurance contracts and unit investment trusts; and
- expanding available exemptions from the filing requirements to cover follow-on offerings of closed-end "tender-offer" funds.

As a practical matter, while the rule would be significantly modified on its face to have a clearer, more streamlined presentation, the substantive changes to the rule would be fairly limited.

BACKGROUND

FINRA Rule 5110 prohibits unfair underwriting arrangements in connection with the public offering of securities. The rule requires member firms participating in a public offering (subject to various filing exemptions) to file information with FINRA regarding the underwriting terms and arrangements, which FINRA reviews to determine whether the underwriting compensation and other terms and arrangements meet the requirements of applicable FINRA rules (including, as well, Rule 5121 (Public Offering of Securities with Conflicts of Interest) and Rule 2310 (Direct Participation Programs)). The rule was initially adopted in 1992 to address unfair dealings between underwriters and issuers and has been revised a number of times since then with the last major revision occurring in 2004.

PROPOSED AMENDMENTS TO RULE 5110

FINRA is proposing many changes to Rule 5110, which would result in a reformatted and more streamlined presentation of the rule.[1] While certain proposed changes are substantive – adding exemptions from the rule's filing requirements, for example, and excluding the prior receipt of issuer securities from the definition of "underwriting compensation" in limited circumstances – many of the changes aim to clarify existing guidance or interpretations of the current rule (the exclusion of Rule 144A and Regulation S offerings, for example), reorganize the rule (moving lists of examples out of the rule to Supplemental Material) and conform terms that are used throughout ("participating member" and "underwriting compensation," for example). While the rule would look different on its face, we believe that the proposed amendments would not result in significant change to the rule's application in most public offerings or in member firms' compliance with the rule.

FINRA's proposed amendments address a number of areas within the rule, including:

- filing requirements;
- filing exemptions;
- disclosure requirements;
- underwriting compensation;
- prohibited terms and arrangements;
- lock-up restrictions;
- valuation of securities; and
- defined terms.

Filing Requirements

Rule 5110 currently requires that members submit to FINRA documents (for example, the registration statement) submitted to or filed with the SEC (or any state securities commission or other regulatory authority) within one business day of the SEC filing. FINRA is proposing to allow members more time to make these required filings with FINRA – within three business days of SEC filing – and will also make

clear that a confidential submission to the SEC (for example, for an emerging growth company) triggers the FINRA filing requirement.

The rule also currently requires the submission of all agreements between the issuer and the underwriters and among the underwriters, as well as any amendments to those agreements. FINRA is proposing to exempt from filing industry-standard master forms of agreement unless specifically requested by FINRA and amendments to already submitted agreements unless the amendments affect the underwriting terms and arrangements.

Filing Exemptions

Rule 5110 currently contains a list of offerings that are exempt from filing but remain subject to the rule's prohibition on unreasonable underwriting terms and arrangements, and a separate list of offerings that are exempt from all requirements of the rule. The proposal also adds an explicit exemption from both the filing requirements and the substantive provisions of the rule for offerings made pursuant to Regulation S and Rule 144A under the Securities Act of 1933. The proposal also clarifies that banks with outstanding long-term investment grade debt with a term of issue of at least four years are excluded from the filing requirements of the rule, just like corporate issuers. FINRA proposes to exempt from the rule's filing requirements (but not substantive terms) follow-on offerings of closed-end "tender offer" funds.[2] Public offerings of insurance contracts and unit investment trusts would be exempt from both the filing requirements and substantive provisions of the rule under the proposal.

Disclosure Requirements

FINRA is proposing to modify the underwriting compensation disclosure requirements. The proposal would continue to require a description of each item of underwriting compensation, but would no longer require a dollar amount ascribed to each individual item of compensation in the disclosure (the rule still will require that the discount or commission be disclosed on the cover page of the prospectus or other offering document). Proposed Supplementary Material would clarify that the rule requires disclosure of any right of first refusal granted to a participating member and its duration, as well as any securities acquired by a participating member and the material terms and arrangements of the acquisition. The proposed Supplementary Material also provides that finder fees, legal fees and expenses of the participating members may be aggregated with other underwriting expenses in the disclosure (rather than separately itemized).

Underwriting Compensation

FINRA is proposing to clarify what types of payments and benefits are considered underwriting compensation. Rule 5110 currently sets forth a list of payments and benefits that are considered "items of value" and provides that "all items of value received or to be received from any source by the underwriter and related persons which are deemed to be in connection with or related to the distribution of the public offering" are included in underwriting compensation. The rule also provides a list of

payments that are not considered "items of value" for these purposes even though deemed to have been received by the underwriter and related persons in connection with, or related to, the public offering. FINRA's proposed amendments would consolidate the multiple provisions of the current rule that address underwriting compensation into a single, new definition of "underwriter compensation" and would eliminate reference to "items of value" altogether. "Underwriting compensation" would be defined as "any payment, right, interest, or benefit received or to be received by a participating member from any source for underwriting, allocation, distribution, advisory and other investment banking services in connection with a public offering" and would include "finder fees and underwriter's counsel fees, including expense reimbursements and securities." The list of "items of value" and payments and benefits that are not considered "items of value" would be relocated from the text of the rule to the Supplementary Material as non-exhaustive lists of examples of what is and is not underwriting compensation. FINRA proposes to add several new items to these lists, as well. For example, the list of underwriting compensation items would include fees and expenses paid or reimbursed to, or paid on behalf of, the participating members, including road show fees and expenses and due diligence expenses, while payment for records management and advisory services received by members in connection with the conversion of an issuer from a mutual holding company to a stock holding company would not be underwriting compensation.

Exceptions from Underwriting Compensation

FINRA proposes to modify exceptions from underwriting compensation. Currently, Rule 5110 provides five exceptions from underwriting compensation for certain acquisitions and purchases of securities. FINRA's proposal would eliminate the exceptions that relate to:

- acquisitions and conversions of securities (securities acquired in a stock split or pro-rata rights or similar offering, for example, or in the conversion of securities, where the underlying security was not deemed to be underwriting compensation); and
- purchases based on a prior investment history to prevent dilution of a long-standing interest in the issuer.

These two categories of securities acquisitions would be added to the list of examples of benefits and payments that are not underwriting compensation in the Supplemental Material.

FINRA would also modify the exceptions that address securities that were acquired as a result of certain bona fide investments and loans. FINRA notes that these exceptions are designed to distinguish securities acquired in bona fide venture capital transactions from securities acquired as underwriting compensation. The rule currently exempts from underwriting compensation securities of the issuer that were purchased in a private placement or received as compensation for a loan or credit facility by affiliates of member firms participating in the offering (via two separate exceptions, each with differing conditions), but limits the availability of the exceptions to those situations where the affiliates have acquired no more than 25 percent of the issuer's equity (calculated immediately following the transaction).

The proposal would broaden these two exceptions by removing the limitation on acquiring more than 25 percent of the issuer's total equity securities.

FINRA also would modify the exception relating to private placements made by institutional investors. Currently, Rule 5110 excludes from underwriting compensation securities that were purchased in, or received as placement agent compensation for, a private placement in the issuer, so long as institutional investors purchased at least fifty-one percent of the total offering, an institutional investor was the lead negotiator or, if the terms were not negotiated, was the lead investor with the issuer to establish or approve the terms of the private placement, and the underwriters and related persons (of the public offering) did not, in the aggregate, purchase or receive as agent compensation more than 20 percent of the total offering. FINRA's proposal would change this 20-percent threshold to 40 percent.[3]

Lock-Up Restriction

Rule 5110 currently requires a 180-day lock-up restriction on securities that are considered underwriting compensation and on some that are not treated as underwriting compensation. FINRA would change the restriction in several respects. First, the lock-up period would begin on the date when sales in the public offering begin, rather than the date of effectiveness of the relevant registration statement (which for a shelf registration statement could be long before the particular offering begins). Second, the lock-up restriction would no longer apply to securities that are subject to an underwriting compensation exemption and securities that are excluded from, or do not otherwise meet, the definition of underwriting compensation. The lock-up restriction also would not apply to securities considered underwriting compensation but that are of an issuer that meets the registration requirements of SEC Registration Form S-3, F-3 or F-10. Finally, the lock-up restriction would no longer prohibit the transfer of the locked-up securities to the member's registered persons or affiliates as long as the securities remained subject to the restriction for the remainder of the lock-up period, and would not prohibit the transfer or sale of the securities back to the issuer in a transaction exempt from registration with the SEC.

Valuation of Securities

Rule 5110 currently prescribes specific methods for calculating the value of certain convertible and non-convertible securities received as underwriting compensation. With regard to options, warrants and other convertible securities received as underwriting compensation, FINRA is proposing to allow members to value them based on any securities valuation method that is commercially available and appropriate for the type of securities, and lists Black-Scholes as an example of such a method for valuing options. The methodology used to value the securities must be filed with FINRA. This change would be reflected in the Supplementary Material.

Defined Terms

FINRA would also consolidate the defined terms in one part of the rule, make the terminology more consistent throughout the rule and simplify and clarify certain terms. For example, the proposal would

introduce a single definition of "underwriting compensation," as discussed above, and would include a definition of "public offering" in this rule.[4] The proposal also would eliminate the term "underwriter and related persons" and instead use the defined term "participating member" throughout the rule for consistency.[5] The proposed amendments would modernize the rule language, using the term "national securities exchange" as defined in the Securities Exchange Act of 1934 rather than referring to specific exchanges, for example, and would add new definitions for terms that are not currently defined in the rule, such as "associated person" (which would refer to the definition in FINRA's Bylaws), "review period" (which would vary depending on the type of offering) and "overallotment option" ("an option granted by the issuer to the participating members for the purpose of offering additional shares to the public in connection with the distribution of the public offering").

Request for Comment

FINRA requests comment on all aspects of the proposal and specifically on the following:

- alternative approaches that FINRA should consider;
- modifications to FINRA's administration of the rule, including operations and processes to receive and review filings;
- impact on Regulation A+ offerings;
- whether the increase in the threshold from 20 percent to 40 percent in connection with the private placement-related exception from underwriting compensation is an appropriate change or should be higher or lower;
- whether the elimination of prescribed valuation methodologies and reference to methods that are commercially available and appropriate is an appropriate approach, and whether the permitted valuation models should be limited to those that are commercially available; and
- whether the proposed amendments would have a material economic impact on investors, issuers and member firms.

Comments must be received by May 30, 2017.

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ENDNOTES

1 FINRA Regulatory Notice 17-15, April 2017, available at http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-15.pdf.

2 These issuers routinely make self-tender offers and need to be in continuous distribution to offset net redemptions. Compensation for distribution of tender offer funds would become subject to the limitations in FINRA Rule 2341 (Investment Company Securities).

3 FINRA notes that, as a practical matter, these private placements typically take place before the syndicate is formed and, therefore, firms do not know at the time whether their participation in the private placement would affect the issuer's future public offering by triggering the threshold.

4 The term "public offering" currently is defined in Rule 5121. As well as adding the definition to Rule 5110 (largely unchanged), FINRA would eliminate the definition in Rule 5121 and instead incorporate the definition in Rule 5110 by reference.

5 "Participating member" would be defined to include any FINRA member participating in the public offering, any affiliate or associated person of the member and any immediate family member other than the issuer.

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