FINRA Amends Certain Provisions of the Corporate Financing and Conflict of Interest Rules

The Financial Industry Regulatory Authority, Inc. ("FINRA") has received Securities and Exchange Commission ("SEC") approval for several amendments to the FINRA corporate financing and conflict of interest rules. A condensed summary of the SEC releases approving the amendments follows.[1]

FINRA Rule 5110 (the "Corporate Financing Rule") generally regulates underwriting compensation and prohibits unfair arrangements in connection with the public offering of securities. Among other provisions, Rule 5110 requires members to file with FINRA information about the securities offerings in which they "participate" and to disclose affiliations and other relationships that may indicate the existence of conflicts of interest. Rule 5110 also imposes lock-up restrictions on certain securities acquired from the issuer and restricts the receipt of certain items of value, such as termination, or "tail," fees and rights of first refusal as to future transactions. In addition, Rule 5121 (the "Conflict of Interest Rule") prohibits FINRA members that have a conflict of interest from participating in a public offering of securities unless certain conditions are met.

Together, the amendments modify the Rules by:

- Excluding from Rule 5110's definition of "participation or participating in a public offering" a FINRA member that acts exclusively as an "independent financial adviser";
- Modifying the lock-up restrictions to exclude certain securities acquired or converted to prevent dilution;
- Clarifying that the information requirements apply only to relationships with a "participating" member (rather than any FINRA member);
- Narrowing the scope of the definition of "control" in Rule 5121;
- Expanding the circumstances under which participating members may receive termination fees and rights of first refusal ("ROFRs");
- Exempting from the Corporate Financing Rule's filing requirements certain exchange-traded funds ("ETFs"); and
- Codifying the requirement to make FINRA filings electronically.

I. Definition of "participation in a public offering" narrowed

Rule 5110(a)(5) defines "participating in a public offering" to include participation in "any advisory or consulting capacity to the issuer related to the offering." Rule 5110(a)(5) has been amended to provide that an "independent financial adviser" that provides advisory or consulting services to the issuer would not meet the definition of "participation in a public offering" as defined in Rule 5110(a)(5) and would therefore not be subject to the compensation limitations of Rule 5110. The amended rule defines an independent financial adviser as "a

[1] SEC Release No. 34-72033; File No. SR-FINRA-2014-003, *Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change to amend FINRA's Corporate Financing Rules to Simplify and Refine the Scope of the Rules* (April 28, 2014), available at http://www.sec.gov/rules/sro/finra/2014/34-72033.pdf and

SEC Release No. 34-72114; File No. SR-FINRA-2014-004, *Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change Relating to Amendments to FINRA Rule 5110 (Corporate Financing Rule—Underwriting Terms and Arrangements) As Amended* (May 7, 2014) available at http://www.sec.gov/rules/sro/finra/2014/34-72114.pdf

member that provides advisory or consulting services to the issuer and is neither engaged in, nor affiliated with any entity that is engaged in, the solicitation or distribution of the offering."

II. Scope of "lock-up restrictions" narrowed

Rule 5110(d)(1) generally includes as underwriting compensation all items of value, which may include unregistered securities, that are acquired (or arranged to be acquired) within the 180 day period prior to the filing of the registration statement ("180-day review period"). Rule 5110(d)(5) provides five exceptions that permit participating members to acquire securities of the issuer during the 180-day review period without the securities being deemed to be underwriting compensation, including the exclusion from underwriting compensation of the receipt of additional securities to prevent dilution of the investor's investment (e.g., securities acquired as a result of a stock-split or a pro-rata rights or similar offering) where such additional securities are received during the 180-day review period or subsequent to the filing of the public offering, but where the original securities were acquired before the 180-day review period or otherwise were not deemed by FINRA to be underwriting compensation, as described in Rule 5110(d)(5)(D).

While these acquisitions and conversions to prevent dilution are excepted from underwriting compensation, they had been subject to the lock-up restrictions of Rule 5110(g)(1). As amended, Rules 5110(d)(5) and 5110(g)(1) now eliminate the lock-up restrictions for these securities in order to treat shares received in an acquisition or conversion to prevent dilution during the 180-day review period in a manner consistent with the treatment provided for the securities on which their acquisition or conversion was based.

III. Affiliation disclosure only as to "participating" members

Subject to certain exceptions, Rule 5110(b)(6)(A)(iii) requires filers to disclose to FINRA information about the affiliation or association with any member of the officers, directors, and certain owners of the issuer. The compensation limitations and other provisions of Rule 5110 and Rule 5121 apply only to members that participate in a public offering. As amended, Rule 5110(b)(6)(A)(iii) no longer requires disclosure regarding whether the issuer's officers, directors, and certain beneficial owners have an affiliation or association with "any" FINRA member and instead only requires such disclosure as to "participating" FINRA members.

IV. Definition of "control" narrowed

Under Rule 5121, the scope of the definition of "control" is considered in determining whether a member and an issuer are deemed to be affiliated for purposes of the conflicts provisions of Rule 5121 and for certain requirements to provide information to FINRA pursuant to Rule 5110. FINRA amended Rule 5121 to narrow the scope of the definition of "control" by eliminating Rule 5121(f)(6)(iii), thereby excluding from the definition "beneficial ownership of 10 percent or more of the outstanding subordinated debt of an entity, including any right to receive such subordinated debt within 60 days of the member's participation in the public offering."

V. Termination fees and ROFRs allowed in certain instances

Rule 5110(f) sets forth terms and arrangements that, when proposed in connection with a public offering of securities, are considered unfair and unreasonable. Rule 5110(f)(2)(D) addresses fees in connection with a public offering of securities that is not completed according to the terms of the agreement between the issuer and underwriter ("terminated offering"). Specifically, Rule 5110(f)(2)(D) generally provides that it is unfair and unreasonable for a member to arrange for the payment of any compensation by an issuer in connection with a terminated offering ("termination fee" or "tail fee"). Rule 5110(f)(2)(D) further clarifies that this prohibition does

not include compensation negotiated and paid in connection with a separate transaction that occurs in lieu of the proposed offering, or reimbursement of out-of-pocket accountable expenses actually incurred by the member. Prior to the recent amendment, Rule 5110(f)(2)(E) provided that, in the event an issuer terminates an offering with an underwriter and subsequently consummates a similar transaction, a termination fee may be permissible under certain circumstances.

FINRA amended Rule 5110(f)(2) to generally permit termination fees where: (1) the agreement between the participating member and the issuer specifies that the issuer has a right of "termination for cause" (i.e., where a member fails materially to perform the underwriting services contemplated in the written agreement); (2) the agreement specifies that an issuer's exercise of its right of "termination for cause" eliminates any obligations with respect to the payment of any termination fee; (3) the amount of any specified termination fee is reasonable in relation to the services contemplated in the written agreement; and (4) the agreement specifies that the issuer is not responsible for paying the termination fee unless an offering or other type of transaction is consummated by the issuer within two years of the date the issuer terminates the engagement with the member.[2]

Prior to being amended, Rule 5110(f)(2)(F) and (G) addressed ROFRs, which provide a FINRA member with the right to underwrite or participate in future public offerings, private placements or other financings of the issuer. Rule 5110(f)(2)(F) deemed as unfair and unreasonable any ROFR provided to a member that: (1) has a duration of more than three years from the date of effectiveness or commencement of sales of the public offering, or (2) provides more than one opportunity to waive or terminate the ROFR in consideration of any payment or fee. Rule 5110(f)(2)(G) prohibited any payment or fee to waive or terminate a ROFR regarding future public offerings, private placements or other financings that exceed specified values or that is not paid in cash.

Historically, FINRA has interpreted the Rules to permit ROFRs only in the case of successful offerings. FINRA has amended its rules to permit ROFRs in both successful and terminated offerings.[3] ROFRs would be permissible where: (1) the agreement between the participating member and issuer specifies that the issuer has a right of termination for cause (i.e., where a member fails materially to perform the underwriting services contemplated in the written agreement); (2) an issuer's exercise of its right of termination for cause eliminates any obligations with respect to the provision of any ROFR; and (3) any fees arising from services provided under a ROFR are customary for those types of services. The Rule continues to provide that the duration of any ROFR must be less than three years from the date of commencement of sales of the public offering (in the case of a successful offering). In the case of a terminated offering, the duration must be less than three years from the date the issuer terminates the engagement. In either case, the agreement may not provide for more than one opportunity to waive or terminate the ROFR in consideration of any payment or fee.

VI. Certain ETFs exempted from filing

Rule 5110(b)(8) generally provides an exemption for investment companies from the filing requirements of the Rule. Due to this exemption, ETFs that are structured as investment companies generally are exempt. However, this exemption does not include certain other ETFs that are not investment companies. While not providing a complete exemption from the application of the Rule's substantive requirements, new Rule 5110(b)(7)(H) now provides an exemption from the filing requirements of the Rule for offerings of securities

[2] The SEC release approving the amended rules notes that this fourth condition intends that that an offering completed within the two-year time frame not involve the member whose engagement was previously terminated. See May 7, 2014 SEC Release, noted above at 3.

[3] Rule 5110(f)(D) was amended and Rule 5110(f)(2)(E) was re-drafted. Rule 5110(f)(2)(G) was redesignated as Rule 5110(f)(2)(F), which prohibits any payment or fee to waive or terminate a ROFR regarding future public offerings, private placements or other financings that exceed specified values or that is not paid in cash.

issued by a pooled investment vehicle (whether formed as a trust, partnership, corporation, limited liability company or other collective vehicle) that is not registered as an investment company under the Investment Company Act and has a class of equity securities listed for trading on a national securities exchange so long as such equity securities may be created or redeemed on any business day at their net asset value per share.

VII. Requirement to file electronically codified

Rule 5110(b) generally provides that no member or person associated with a member shall participate in any manner in a public offering of securities subject to Rules 2310, 5110 or 5121 unless the specified documents and information relating to the offering have been filed with and reviewed by FINRA. FINRA amended Rule 5110(b)(5) to codify the requirement that filings be made electronically. References in the rule to paper filings were eliminated.

The amended rules are now reflected in the FINRA rules on line.[4]

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; Mary Stokinger at 212.701.3430 or mstokinger@cahill.com; or Lindsay Flora at 212.701.3429 or lflora@cahill.com.

[4] Available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=607.