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FINRA Proposes Amendment to Corporate Financing Rule and Conflict of Interest Rule

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FINRA Rule 5110, the corporate financing rule, regulates the terms and arrangements of securities underwriting conducted by FINRA member broker-dealers, which covers virtually all of the US securities industry. FINRA has proposed amendments to the corporate financing rule that would (a) exclude "independent financial advisers" from the application of the corporate financing rule, (b) limit lock-up restrictions for certain securities acquired or converted to prevent dilution, and (c) clarify information requirements for public offering filings. In addition, FINRA has also proposed to narrow the scope of the definition of "control" for purposes of FINRA Rule 5121, the conflict of interest rule, to exclude holders of subordinated debt. Separately, FINRA has proposed other amendments to the corporate financing rule that would (a) expand the circumstances under which FINRA member broker-dealers and issuers may negotiate termination fees and rights of first refusal and (b) exempt all exchange-traded funds from the filing requirements under that rule.

Introduction

On January 9, 2014, the US Financial Industry Regulatory Authority, Inc. ("FINRA") submitted proposed amendments to its Rule 5110 (the "Corporate Financing Rule") and 5121 to the Securities and Exchange Commission ("SEC"). If adopted, the amendments (the "Amendment No. 1") would (a) exclude "independent financial advisers" from being considered as "participating in a public offering;" (b) modify the lock-up restrictions under

Rule 5110(g)(1) to exclude certain securities acquired or converted to prevent dilution; and (c) clarify that information requirements for filings submitted under Rule 5110 apply only to relationships with a "participating" member. In addition, FINRA has also proposed to narrow the scope of the definition of control in Rule 5121 (the "Conflict of Interest Rule," and together with the Corporate Financing Rule, the "Rules") by excluding beneficial owners of 10% or more of the outstanding subordinated debt of an entity.

Also, on January 24, 2014, FINRA proposed other amendments to the Corporate Financing Rule to the SEC. If adopted, the amendment (the "Amendment No. 2," and together with Amendment No. 1, the "Amendments") would (a) expand the circumstances under which FINRA member broker-dealers and issuers may negotiate termination fees and right of first refusals ("ROFRs"); and (b) exempt all exchange-traded funds ("ETFs") from the filing requirements under that rule.

The SEC published Amendment No. 1 and Amendment No. 2 for comment on January 23, 2014, and February 4, 2014, respectively.[1] Comments for Amendment No. 1 are due February 19, 2014. Comments for Amendment No. 2 are due 21 days after its publication in the Federal Register.

Summary of the Rules

1. The Corporate Financing Rule

The Corporate Financing Rule is the principal rule regulating compensation to underwriters and other FINRA-member participants in public offerings of securities. The definition of "participation in a public offering" has traditionally been very broad, including both participation as an underwriter, and also participation in the form of financial advisory services.

The Corporate Financing Rule regulates compensation in three basic ways: (i) by aggregating all "items of value" received by underwriters and other related persons in connection with the public offering, deeming such items of value to be "compensation in connection with the public offering," and limiting that compensation; (ii) placing a prohibition on the receipt of certain items of value in connection with participation in a public offering (such as certain forms of termination fees and certain ROFR structures); and (iii) requiring disclosure of all items of value that are deemed to be compensation to the underwriters in connection with the public offering in filings to FINRA. The Corporate Financing Rule also places lock-up restrictions on securities acquired within 180 days prior to the required submission date of the offering (the "180-day review period") under the Corporate Financing Rule to the extent the same are deemed to be compensation to the participating members.

[1] The proposed Amendment No. 1 and Amendment No. 2 are available on FINRA's website. FINRA did not solicit or receive any written comments for the proposed Amendment No. 1. On June 6, 2012, FINRA published Regulatory Notice 12-27, which proposed amendments substantially similar to Amendment No. 2. FINRA received comments from ALPS Distributors, Inc., Securities Industry and Financial Markets Association and American Bar Association. FINRA Regulatory Notices and NASD Notices to Members are available at FINRA's Internet website, www.finra.org.

Amendment No. 1 would, among other things, exclude "independent financial advisers" from the Corporate Financing Rule and exclude certain securities acquired within the 180-day review period from lock-up restrictions.[2] Amendment No. 2 would, among other things, exclude certain termination fees and ROFRs from the list of prohibited items of value under certain circumstances and exempt ETFs from the filing requirements under the Corporate Financing Rule.

2. The Conflict of Interest Rule

The Conflict of Interest Rule prohibits underwriters from participating in a public offering if that underwriter has a "conflict of interest," subject to certain exceptions. A conflict of interest is deemed to exist if at the time of the underwriter's participation in the public offering, (1) the securities are to be issued by the underwriter; (2) the issuer controls, is controlled by or is under common control with the underwriter or the underwriter's associated persons; (3) at least 5% of the net offering proceeds, not including underwriting compensation, are intended to be either (a) used to reduce or retire the balance of a loan or credit facility extended by the underwriter, its affiliates and its associated person, in the aggregate or (b) otherwise directed to the underwriter, its affiliates and associated persons, in the aggregate; or (4) as a result of the offering and any transactions contemplated at the time of the offering, either the underwriter will either (a) be an affiliate of the issuer or (b) become publicly owned, or the issuer will become a FINRA member or form a broker-dealer subsidiary. Under the current rule, "control" means (1) beneficial ownership of 10% or more of the outstanding common equity of an entity, including any right to receive such securities within 60 days of the member's participation in the public offering; (2) the right to 10% or more of the distributable profits or losses of an entity that is a partnership, including any right to receive an interest in such distributable profits or losses within 60 days of the member's participation in the public offering; (3) beneficial ownership of 10% 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; (4) beneficial ownership of 10% or more of the outstanding preferred equity of an entity, including any right to receive such preferred equity within 60 days of the member's participation in the public offering; or (5) the power to direct or cause the direction of the management or policies of an entity.[3] Under Amendment No. 1, beneficial ownership of 10% or more of the outstanding subordinated debt of an entity will no longer be deemed to be "control."

Description of the Amendments

1. Exception from the Definition of "Participation in a Public Offering" for Independent Financial Advisers

FINRA has proposed to remove independent financial advisers who provide advisory or consulting services to the issuer from being considered to be participating in an offering and thus excluding them from the application of the Corporate

[2] For more information regarding the Corporate Financing Rule, you may refer to "FINRA regulation of corporate financing: FINRA amends rule change proposals to NASD Corporate Financing Rule 2710 and Conflict of Interest Rule 2720" (December 2007), available at http://www.shearman.com/cm_120307/; see also "NASD Revises Proposals to Amend the Corporate Financing Rules with Respect to Regulation of Shelf Offerings" (May 2006), available at http://www.shearman.com/cm_051506/, and "SEC Adopts Major Changes to NASD Corporate Financing Rule" (April 2004), available at: http://www.shearman.com/sf_0404/.

[3] For more information regarding the Conflict of Interest Rule, you may refer to "SEC Approves FINRA Amendment to Conflict of Interest Rules for Securities Offerings" (June 2009), available at http://www.shearman.com/~/media/Files/NewsInsights/Publications/2009/06/SEC%20Approves%20FINRA%20Amendments%20to%20Conflict%20of%20Int__/Files/Click%20here%20to%20view%20memo%20SEC%20Approves%20FINRA%20Amend__/FileAttachment/AM062309SECApprovesFINRAAmendmentstoConflictofIn__.pdf.

Financing Rule. Under Amendment No. 1, "independent financial adviser" is a "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."[4] Financial advisers would still be deemed to be participating in an offering (and would have all of the compensation received by them and their affiliates be included in the compensation limits under the Corporate Financing Rule) if they or their affiliates engage in distribution or solicitation activities in connection with the offering. Amendment No. 1 recognizes the emergence of a group of broker-dealers who work solely in an advisory capacity to the issuer in connection with the consummation of a public offering. These broker-dealers are not underwriters and do not participate in the public offering.

2. Exclusion of Anti-Dilution Acquisitions from the Lock-Up Provisions of the Corporate Financing Rule

Amendment No. 1 will also exclude from lock-up any shares received in an acquisition or conversion to prevent dilution during the 180-day review period, provided that the anti-dilution right is based on securities received outside the 180-day review period. Currently, such securities are excluded from the definition of "underwriters' compensation" under Rule 5110(d)(5); the same securities are, however, still potentially subject to lock-up under Rule 5110(g)(1). Amendment No. 1 would eliminate the lock-up requirements under Rule 5110(g)(1) for these securities.

3. Elimination of Required Disclosure Regarding Non-Participating Broker-Dealers

Amendment No. 1 would also eliminate the need to disclose to FINRA affiliations or associations of the officers, directors, and certain owners of the issuer with non-participating FINRA members in filings submitted under the Corporate Financing Rule. Specifically, Amendment No. 1 would change the disclosure requirement to require "a statement of the association or affiliation with any participating member of any officer or director of the issuer, of any beneficial owner of 5% or more of any class of the issuer's securities, and of any beneficial owner of the issuer's unregistered equity securities that were acquired during the 180-day period immediately preceding the required filing date of the public offering." This change would thus exclude "independent financial advisers" from the disclosure requirement.

4. Deletion of Subordinated Debt from the Definition of "Control" for Purposes of the Conflict of Interest Rule

Furthermore, Amendment No. 1 would exclude beneficial owners of 10% or more of the outstanding subordinated debt of an entity from the definition of "control" in Conflict of Interest Rule. This definitional change would exclude affiliations between an issuer and a member arising from a beneficial ownership of 10% or more of the outstanding subordinate debt from giving rise to a conflict of interest and would remove the requirement to disclose such a relationship in a filing submitted under the Corporate Financing Rule.[5]

[4] Given that the proposed Amendment No. 1 would exclude FINRA-member broker-dealers that are financial advisers from the definition of "participation" in a public offering, it is reasonable to assume that non-broker-dealers (who are outside the jurisdiction of FINRA and of the Corporate Financing Rule), such as private equity and other financial sponsors, are similarly excluded in respect of any fees that they receive upon consummation of a public offering in respect of advice to the issuer. We note, however, that FINRA did not address this issue in the proposal.

[5] See FINRA Rule 5110(b)(6)(A)(iii) and Rule 5121(f)(1).

5. Exclusion of Termination Fees and ROFRs as Prohibited Items of Value under Certain Circumstances

As noted above, under the Corporate Financing Rule, termination fees are not currently permitted under Rule 5110(f), except in very limited circumstances. Amendment No. 2 would generally permit terminations fees where:

(1) the agreement between the participating member and the issuer specifies that the issuer has a right of "termination for cause;"[6]

(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;[7]

(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 (without involvement of the member) within two years of the date the engagement is terminated with the member by the issuer.

Historically, FINRA has only considered permitting termination fee arrangements where the applicable transaction is either an exchange offer, or similar offering and/or where members provide substantial structuring or advisory services beyond that traditionally provided in connection with a distribution of a public offering. Thus, the amendment would provide members and issuers with greater flexibility to negotiate termination fees.

Further, Amendment No. 2 would permit ROFRs where: (1) the agreement between the participating member and issuer specifies that the issuer has a right of "termination for cause;" (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.

Currently, Rule 5110(f)(2)(F) deems 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) 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. Upon adoption of Amendment No. 2, the Corporate Financing Rule would continue to provide that the duration of any ROFR may not be for more 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 may not be for more than three years from the date the engagement is terminated by the issuer. In both cases, the agreement may not provide for more than one opportunity to waive or terminate the ROFR in consideration of any payment or fee.

[6] "Termination for cause" would be dictated by the agreement, but would be required to include a member's material failure to perform the underwriting services contemplated in the written agreement. "Termination for cause" is not required to include events that are outside the participating member's control.

[7] Broker-dealers would continue to be permitted to receive reimbursement of out-of-pocket, bona fide, accountable expenses incurred by its participation in connection with a terminated offering.

6. Exemption of ETFs from Filing Requirements

Amendment No. 2 would exempt all ETFs from the filing requirements under the Corporate Financing Rule. Currently, investment companies are exempt from the filing requirements under the rule; thus, ETFs that are not structured as investment companies are not exempt. The amendment would allow all ETFs to be exempt from the filing requirements regardless of whether they are structured as investment companies.

Conclusion

With this proposed rule changes, FINRA seeks to (1) exclude "independent financial advisers" from being considered as "participating in a public offering;" (2) modify the lock-up restrictions to exclude certain securities acquired or converted to prevent dilution; (3) clarify that information requirements for filings submitted under Rule 5110 apply only to relationships with a "participating" member; (4) narrow the scope of the definition of control in Rule 5121 by excluding beneficial owners of 10% or more of the outstanding subordinated debt of an entity; (5) expand the circumstances under which FINRA member broker-dealers and issuers may negotiate termination fees and rights of first refusal; and (6) exempt all ETFs from the filing requirements under the Corporate Financing Rule. In this regard, Amendment No. 1 represents a group of technical changes that FINRA is proposing in order to streamline the workings of the corporate financing rule and conflict of interest rule, while Amendment No. 2 would provide greater flexibility to members and issuer to negotiate for termination fees and ROFRs.

Both sets of changes are generally welcome inasmuch as they recognize and have some of the complexities of compliance with the Rules and also broaden the ability of members to receive compensation for (what in many cases is substantial) efforts in respect of offerings that do not proceed.

In each case, FINRA is seeking to smoothen specific situations that, while currently caught by the disclosure or prohibitive provisions of the corporate financing rules, do not raise the same regulatory concerns as the activities that the Rules principally address.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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