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Client Alert Commentary

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SEC Approves Significant Amendments to FINRA Rules 5110 and 5121

The amendments simplify and refine the scope of FINRA's corporate financing and conflict of interest rules in several important respects.

The Securities and Exchange Commission (SEC) recently approved two proposals from the Financial Industry Regulatory Authority, Inc. (FINRA) to amend FINRA Rules 5110 (Rule 5110 or the Corporate Financing Rule) and 5121 (Rule 5121 or the Conflict of Interest Rule) (collectively, the Rules).[1] Together, the changes modify the scope of FINRA's rules relating to FINRA members participating in public offerings by:

- Excluding from the Corporate Financing Rule's definition of "participation or participating in a public offering" a FINRA member that acts exclusively as an "independent financial adviser"
- Excluding from the current lock-up restrictions of the Corporate Financing Rule certain securities acquired by a participating member (as defined in Rule 5110) as a result of an issuer reorganization or conversion to prevent dilution
- Limiting the Corporate Financing Rule's affiliation disclosure requirements to apply only to relationships with "participating" members (rather than ***any*** FINRA members)
- Narrowing the scope of the definition of "control" in the Conflict of Interest Rule
- 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)

As discussed below, these amendments should provide significant relief to market participants that were previously subject to certain restrictions and requirements under the Rules relating to activities that arguably did not implicate the regulatory concerns that the Rules were designed to address.

Regulatory Framework

The Corporate Financing Rule is the principal FINRA rule regulating compensation to underwriters participating in public offerings of securities. Under the Corporate Financing Rule, FINRA members and their associated persons are prohibited from participating in a public offering of securities if the underwriting terms and conditions, including the amount of compensation to be received, are unfair or

unreasonable.[2] Among other Corporate Financing Rule requirements, FINRA members must disclose all items of value they and their "related persons" have received or will receive in connection with or related to the distribution of the public offering.[3] Subject to certain exceptions, the Corporate Financing Rule also imposes restrictions on the receipt of certain items of value, such as termination or "tail" fees and ROFRs and applies lock-up restrictions to securities participating members acquire during the public offering review period, which in general is the period beginning 180 days prior to the initial SEC filing for the offering and ending 90 days following the effective date of the offering (the Review Period).[4]

Separately, the Conflict of Interest Rule prohibits a FINRA member from participating in a public offering of securities if that FINRA member (or any of its affiliates or associated persons) has a "conflict of interest" (as such term is defined for purposes of the rule) unless certain conditions are met.[5] In addition to other scenarios, a conflict of interest is deemed to exist where the issuer controls, is controlled by or is under common control with the FINRA member or the FINRA member's associated persons.[6] The prior version of the Conflict of Interest Rule defined "control" to mean, among other things, beneficial ownership of 10% or more of an entity's outstanding subordinated debt, including any right to receive such subordinated debt within 60 days of the FINRA member's participation in the public offering.[7] The Rule 5121 definition of "control" is also incorporated by reference in the Corporate Financing Rule for purposes of that rule's informational and other requirements.[8]

Summary of Key Changes

Amendments Approved in the April 28 Order

Exception for Independent Financial Advisers

As noted above, the restrictions in the Corporate Financing Rule apply specifically to FINRA members or persons associated with a FINRA member who "participate" in public offerings of securities.[9] The phrase "participation in a public offering" has traditionally been defined very broadly to include both participation as an underwriter as well as participation as a financial adviser or consultant to the issuer.[10] The revised Corporate Financing Rule amends the definition of "participation or participating in a public offering" to provide that an "independent financial adviser" that solely delivers advisory or consulting services to an issuer would not be deemed to be "participating" in a public offering of an issuer's securities and, as a result, would not be subject to the compensation limitations or disclosure requirements of the Corporate Financing Rule.[11] This change was made, according to FINRA, because unlike cases in which a FINRA member is involved in distribution and solicitation activities, a FINRA member that solely provides advisory or consulting services typically would not have a significant degree of leverage over an issuer.[12]

The amendments to the Corporate Financing Rule define "independent financial adviser" as "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."[13] FINRA noted that under the revised Corporate Financing Rule, issuers are free to engage an independent financial adviser to provide advice regarding the issuer's financing options, the benefits and disadvantages of pursuing a public offering, and the underwriters' proposed terms.[14] However, if a FINRA member provides advisory or consulting services to an issuer and one or more of its affiliates also provides distribution or solicitation services, all compensation received by the FINRA member and its affiliates would be subject to the Corporate Financing Rule. Finally, FINRA specifically noted that should a FINRA member engage in solicitation or distribution activities in addition to providing advisory or consulting services, the exclusion of the advisory-related compensation would not be available and all of the compensation received by that FINRA member in connection with the offering would be subject to the Corporate Financing Rule's compensation limitations and disclosure requirements.[15]

Lock-up Restrictions

The Corporate Financing Rule generally includes as underwriting compensation all "items of value," including securities of the issuer received or acquired by a participating member during the Review Period.[16] Rule 5110(d)(5) provides several exceptions, however, pursuant to which participating FINRA members may acquire securities of the issuer during the Review Period without such securities being deemed to be underwriting compensation. Rule 5110(d)(5)(D) provides an exception from underwriting compensation for the receipt of additional securities to prevent dilution of the investor's existing investment where such additional securities are received during the Review Period and the original securities were acquired prior to the Review Period. Specifically (and subject to a number of other conditions), the exception applies when the additional securities are acquired due to: (i) a stock split or pro-rata rights or similar offering; (ii) a conversion of securities that FINRA has not deemed to be underwriting compensation; and (iii) certain rights of preemption.[17]

Despite their exclusion from underwriting compensation under Rule 5110(d)(5)(D), FINRA previously required that securities acquired to prevent dilution remained subject to the lock-up restrictions set forth in Rule 5110(g)(1). As a result, these securities (subject to limited exceptions) could not be sold during the offering or sold or otherwise transferred for a period of 180 days immediately following the effective date or commencement of sales in the public offering. In its proposed rule change, FINRA stated that subjecting securities acquired or converted to prevent dilution during the Review Period to the lock-up restrictions when they are not considered items of value does not provide any meaningful investor protections and indeed may impose unnecessary burdens on firms to track and monitor compliance with the lock-up provisions.[18] Accordingly, the revised Corporate Financing Rule eliminates the lock-up restrictions for these securities.[19]

Information Requirements

In general, Rule 5110(b)(6)(A)(iii) requires disclosure to FINRA of information regarding the affiliation or association between FINRA members and the officers, directors and certain beneficial owners of the issuer. As previously written, this rule required disclosure to FINRA regarding such persons' affiliation or association with "any member."[20] Because the compensation limitations and other provisions of Rule 5110 and Rule 5121 apply only to FINRA members that "participate" in a public offering, however, FINRA agreed to narrow the scope of the rule such that affiliation disclosure will now only be required with respect to "participating" FINRA members.[21] According to FINRA, the affiliation of issuer-side personnel with non-participating FINRA members does not present the type of concerns that the Corporate Financing Rule is designed to address and, thus, requiring such disclosure is unnecessary.[22] This change should aid considerably in due diligence efforts involved in complying with the Corporate Financing Rule's informational requirements.

Definition of "Control"

The scope of the definition of "control" relates to the determination of whether a FINRA member and an issuer are deemed to be affiliated for purposes of the Conflict of Interest Rule and for certain requirements in the Corporate Financing Rule. As noted above, ownership of 10% or more of the outstanding subordinated debt of an entity was previously deemed to constitute "control" for purposes of the Rules even though such ownership, in and of itself, would ordinarily not be deemed to constitute control under general federal securities law principles. FINRA now agrees that ownership of subordinated debt is not a meaningful measure of control or affiliation and has thus eliminated this element from the control definition.[23]

Amendments Approved in the May 7 Order

Termination Fees and ROFRs

FINRA Rule 5110(f)(2) sets forth certain terms and arrangements that, when proposed in connection with a public offering of securities, are considered unfair and unreasonable. Although the rule appears on its face to permit termination or "tail" fee arrangements in connection with a public offering, historically, FINRA has only permitted such fees (in which the participating member is paid for services provided even if the offering is not consummated or is consummated without the participation of the member) in very limited situations. In particular, FINRA has allowed these fees in connection with exchange offers or similar transactions in which the participating member has provided substantial structuring or advisory services beyond those traditionally provided in connection with the distribution of a public offering.[24] This position effectively forced FINRA members and their affiliates to forego fees in connection with certain transactions even where services were provided over a significant period of time and the issuer had agreed to pay such fees pursuant to an arms'-length negotiated agreement. After considerable discussion with industry participants, FINRA has re-evaluated this approach and has now determined that allowing FINRA members to receive termination fees in connection with ordinary public offerings — provided certain criteria are met — is appropriate. Under the revised Corporate Financing Rule, FINRA will permit termination fees where:

- The agreement between the participating member and the issuer specifies that the issuer has a right of "termination for cause" (including where the participating member materially fails to perform the underwriting services contemplated in the written agreement);

- The issuer's exercise of its right of "termination for cause" eliminates any obligations of the issuer with respect to the payment of any termination fee;

- The amount of any specified termination fee is reasonable in relation to the services contemplated in the written agreement; and

- 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 participating member) within two years of the date the issuer terminates the engagement with the participating member.[25]

Similarly, FINRA has re-evaluated its position with respect to ROFRs and will now allow participating members to retain ROFRs to participate in future transactions even if the public offering in which the ROFR was granted is not consummated. Specifically, such continuing ROFRs will be permitted where:

- The agreement between the participating member and issuer specifies that the issuer has a right of termination for cause (including where the participating member materially fails to perform the underwriting services contemplated in the written agreement);

- The issuer's exercise of its right of termination for cause eliminates any obligation of the issuer with respect to the provision of any ROFR; and

- Any fees arising from services provided under a ROFR are customary for those types of services.[26]

The Corporate Financing Rule continues to provide that the duration of any ROFR must not be in excess of three years from (i) the date of commencement of sales in the public offering or (ii) 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.[27]

These changes likely will significantly impact the structure of engagement letters between participating members and issuers relating to public offerings (or otherwise entered into within the Review Period) and should also substantially reduce, if not eliminate, discussions with FINRA staff regarding tail fee and ROFR provisions in engagement letters when seeking "no objections" clearance for filed public offerings. As a result, we expect the FINRA clearance process for filed offerings will become more efficient from a time and cost perspective as it relates to these issues.

Filing Requirements for Exchange-Traded Funds

FINRA Rule 5110(b)(8) generally provides an exemption for investment companies from the requirements of the Corporate Financing Rule. However, this exemption does not cover ETFs that are not structured as investment companies. While not providing a complete exemption from the application of the rule's substantive requirements, the revised Corporate Financing Rule now provides an exemption from the filing requirements of the rule for offerings of securities 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.[28]

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Endnotes

1 *See* Order Approving a Proposed Rule Change to amend FINRA's Corporate Financing Rules to Simplify and Refine the Scope of the Rules, Exchange Act Release No. 34-72033; File No. SR-FINRA-2014-003 (Apr. 28, 2014) [hereinafter, the April 28 Order]; Order Approving a Proposed Rule Change Relating to Amendments to FINRA Rule 5110 (Corporate Financing Rule—Underwriting Terms and Arrangements), Exchange Act Release No. 34-72114; File No. SR-FINRA-2014-004 (May 7, 2014) [hereinafter, the May 7 Order]. The amendments approved in the April 28 Order are effective as of May 28, 2014; the amendments approved in the May 7 Order are effective as of May 15, 2014.

2 *See* Rule 5110(f).

3 *See* Rule 5110(c) and (d).

4 *See* Rule 5110(d).

5 *See* Rule 5121(a).

6 *See* Rule 5121(f)(5).

7 *See* Rule 5121(f)(6)(A)(iii).

8 *See* Rule 5110(a).

9 *See* Rule 5110(b) and (c).

10 *See* Rule 5110(a)(5).

11 *See* Proposed Rule Change to Amend FINRA's Corporate Financing Rules to simplify and refine the scope of the Rules (Jan. 19, 2014) [hereinafter, the 003 Proposal], available at: http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p426843.pdf.

12 *See* 003 Proposal at p. 5.

13 *See* 003 Proposal at Exhibit 5, revised 5110(a)(5).

14 *See* 003 Proposal at p. 6.

15 *See* 003 Proposal at p. 5.

16 *See* Rule 5110(c) and (d).

17 *See* Rule 5110(d)(5)(D).

18 *See* 003 Proposal at p. 8.

19 *See* 003 Proposal at Exhibit 5, revised Rule 5110(d)(5).

20 *See* Rule 5110(b)(6)(A)(iii).

21 *See* 003 Proposal at Exhibit 5, revised Rule 5110(b)(6)(A)(iii).

22 *See* 003 Proposal at p. 8.

23 *See* 003 Proposal at p. 20.

24 *See* Proposed Rule Change Relating to Amendments to FINRA Rule 5110 (Corporate Financing Rule—Underwriting Terms and Arrangements) (January 14, 2014) [hereinafter, the 004 Proposal], available at: http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p438040.pdf

25 *See* 004 Proposal at Exhibit 5, revised Rule 5110(f)(2)(D)(ii); *see also* FINRA Regulatory Notice 14-22 (May 2014).

26 *See id.*

27 *See* 004 Proposal at Exhibit 5, revised Rule 5110(f)(2)(E).

28 *See* 004 Proposal at Exhibit 5, revised Rule 5110(b)(7)(H).