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Legal Update
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Proposed FINRA Corporate Financing Rule Change

On October 30, 2018, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed a proposed rule change to amend FINRA Rule 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements) (the "Rule"), which is the main FINRA rule regarding compensation in securities offerings, with the Securities and Exchange Commission ("SEC"). The Rule was last revised in 2004 to reflect the expanded variety of FINRA members' activities and has once again been revisited as part of FINRA's retrospective self-review. The October 30, 2018 proposed Rule is the result of extensive industry review and consultation, including FINRA Regulatory Notice 17-15 and the related industry comments and reflects FINRA's goals of simplifying, modernizing and clarifying its rules. The provisions of the proposed Rule are summarized below.

General Filing Requirements

Filing deadline. The proposed Rule allows FINRA member firms three business days (previously one business day) from the time of filing with the SEC to complete the required FINRA filing. In addition, the text of the proposed Rule clarifies various aspects of the existing Rule, including that a managing underwriter's filing relieves other underwriters of the obligation to file and the managing underwriter's notification responsibilities with respect to the other underwriters.

Scope of documentation required. The proposed Rule clarifies and simplifies the documentation and information filing requirements. The Rule limits when industry standard master forms (only when specifically requested) and amendments to previously filed documents (only if the amended document includes changes to the underwriting terms and arrangements) must be filed. A representation as to whether any participating FINRA member, including associated persons and affiliates, beneficially owns five percent or more of any class of the issuer's equity or equity-linked securities (previously any class of securities) and an estimate of the maximum value of each item of underwriting compensation are also required to be filed.

Filing Requirements for Shelf Offerings

Exempt shelf offerings. The proposed Rule codifies the existing exemption for seasoned issuers by removing the previous references to the pre-1992 SEC Form S-3 eligibility criteria and adding the defined term "experienced issuer." An experienced issuer is defined as an issuer with a 36-month reporting history and at least $150 million aggregate market value of voting stock held by non-affiliates or, alternatively, an aggregate market value of voting stock held by non-affiliates of at least $100 million and an annual trading volume of three million shares.

Non-exempt shelf offerings. The proposed Rule streamlines the filing requirements for shelf offerings by requiring only the base shelf registration statement SEC file number to be provided to FINRA. Additional documents must be provided only if specifically requested and FINRA's review will occur on a post-takedown basis.

Exemptions from Filing and Substantive Requirements

Filing exemption. The proposed Rule clarifies, consistent with existing interpretation, that the exemption for corporate issuers with outstanding debt securities includes banks.

Filing and substantive exemption. The proposed Rule expands the list of exempt offerings to include public offerings of closed-end "tender offer" funds, insurance contracts and unit investment trusts. In addition, the proposed Rule explicitly excludes from the definition of "public offering" securities offerings that are exempt from registration pursuant to Sections 4(a)(1), (2) and (6) of the Securities Act of 1933 (the "Securities Act") and specified provisions of Regulation D and securities that are exempt from registration pursuant to
Rule 144A under the Securities Act, Regulation S, and Section 3(a)(12) of the Securities Exchange Act of 1934.

Disclosure Requirements

The proposed Rule continues to require a description of each item of underwriting compensation, including any right of first refusal and the material terms related to any securities acquired by the underwriters. While each item of underwriting compensation must be described, the proposed Rule no longer requires a value to be ascribed to each individual item of compensation. Disclosure of the maximum aggregate amount of all underwriting compensation and the prospectus cover page disclosure of the discount or commission to the public offering price are sufficient under the proposed Rule.

Underwriting Compensation

Underwriting compensation defined. The proposed Rule consolidates the various provisions relating to underwriting compensation into a single definition. Underwriting compensation is "any payment, right, interest, or benefit received or to be received by a participating FINRA member from any source for underwriting, allocation, distribution, advisory and other investment banking services in connection with a public offering" and includes any "finder's fees, underwriter's counsel fees, and securities." The proposed Rule also provides additional examples to clarify the types of payments or benefits that are included within the new definition of underwriting compensation and, in order to provide greater flexibility, takes a principles-based approach regarding whether issuer securities acquired from third parties or in directed sales programs may be excluded from underwriting compensation.

Review period. Under the current Rule, any items of value received during the period commencing 180 days prior to the filing date of a registration statement and running until 90 days following the effectiveness of the applicable registration statement or the commencement of sales are presumed to be underwriting compensation. The proposed Rule, to better reflect various offering types, creates a new defined term, "review period," and provides for various review periods depending on the type of offering.

Venture Capital and Related Exceptions

Exceptions from the definition of underwriting compensation. The proposed Rule modifies, clarifies and expands the current venture capital exceptions from underwriting compensation in order to facilitate participation in venture capital transactions. Securities acquisitions and conversions to prevent dilution and securities purchases based on prior investment history are excluded from the definition of underwriting compensation under the proposed Rule, and two additional exceptions under the current Rule are modified by the proposed Rule. The exception regarding purchases and loans by certain affiliates and investments in and to certain issuers is no longer subject to a 25% cap on the issuer's total equity securities and broadens the scope of the affiliates that are eligible to use this exception to include direct, indirect and newly

formed entities that are in the business of making investments and loans.

Private placements with institutional investors. The proposed Rule expands the scope of who may benefit from the venture capital private placement exception to any service provider in a private placement in an attempt to recognize the value of rendering services other than placement agent services, such as roles as finders and financial advisors. However, this provision also makes clear that the exception is only available if institutional investors unaffiliated with any participating FINRA members purchase at least 51% of the securities sold in the private placement at the same time and on the same terms and that the participating FINRA members do not, in the aggregate, receive more than 40% (raised from 20%) of the total number of securities sold in the private placement.

Co-investments with certain regulated entities. A new exception from the definition of underwriting compensation is included in the proposed Rule. Securities acquired in a private placement before the required filing date of the public offering by a participating FINRA member are not considered underwriting compensation if at least 15% of the total number of securities sold in the private placement were acquired, at the same time and on the same terms, by one or more entities that is an open-end investment company not traded on an exchange and no such entity is an affiliate of a FINRA member participating in the offering.

Delayed offerings. The proposed Rule change also seeks to provide additional flexibility to rely on the venture capital exceptions where the public offering has been significantly delayed. When a public offering has been significantly delayed and an issuer requires funding, a principles-based approach will be used to determine whether securities acquired in a transaction that, except for the timing, would otherwise meet the requirements of a venture capital exception, should be considered underwriting compensation.

Non-Convertible or Non-Exchangeable Debt Securities and Derivatives

As underwriting compensation. The proposed Rule expressly provides that whether non-convertible or non-exchangeable debt securities and derivatives are considered underwriting compensation depends on whether such instruments are acquired in a transaction related to a public offering. Instruments acquired in a transaction unrelated to a public offering are not subject to the Rule. Non-convertible or non-exchangeable debt securities and derivatives acquired in a transaction related to a public offering would be considered underwriting compensation. A description of such non-convertible or non-exchangeable debt securities and derivative instruments acquired in a transaction related to a public offering must be filed with FINRA, and a registered principal or senior manager of the participating FINRA member must make a representation that it has determined that the transaction was or will be entered into at a fair price.

Valuation. The proposed Rule clarifies that the valuation of non-convertible or non-exchangeable debt securities and derivatives that are considered underwriting compensation (acquired in a transaction related to a public offering) depends on whether they were acquired at a fair price. Instruments acquired at a fair price, while considered underwriting compensation, will be deemed to have no compensation value. Instruments that are not acquired at a fair price will be considered underwriting compensation and subject to the Rule.

Lock-up restrictions. Non-convertible or non-exchangeable debt securities and derivative instruments acquired in transactions related to a public offering, other than derivative instruments acquired in a hedging transaction at a fair price, will be subject to the lock-up restrictions under the proposed Rule.

Lock-Up Restrictions

The proposed Rule provides that the lock-up restriction on securities that are considered underwriting compensation will begin on the date of commencement of sales rather than upon the date of effectiveness of the applicable registration statement and that the lock-up restriction must be disclosed in the prospectus. The proposed rule also provides for the following exceptions from the lock-up restrictions:

- Securities acquired from an issuer that meets the eligibility criteria to use SEC Registration Forms S-3, F-3 or F-10;
- Securities acquired in a transaction meeting one of the venture capital exceptions discussed above;
- Securities that were received as underwriting compensation and are registered and sold as part of a firm commitment offering;
- Transfers or sales back to the issuer in a transaction exempt from registration under the Securities Act; and
- Transfers to a FINRA member's registered persons or affiliates if all of the transferred securities remain subject to the lock-in restriction for the remainder of the lock-in period.

Prohibited Terms and Arrangements

The proposed Rule clarifies and amends the list of prohibited and unreasonable terms and arrangements in connection with public offerings of securities and clarifies the scope of activities that are deemed related to the public offering.

Definitions

The proposed Rule consolidates all of the definitions into a single section and makes the terminology more consistent throughout the Rule's various provisions.

The full text of the proposed rule change is available at: http://www.finra.org/sites/default/files/rule_filing_file/SR-FINRA-2018-038.pdf.

The proposed Rule is currently under review by the SEC, and FINRA will announce the implementation date of the proposed rule change in a Regulatory Notice to be filed no later than 90 days following SEC approval. The implementation date will be no later than 180 days following the publication of such Regulatory Notice.

For more information section about the topics raised in this Legal Update, please contact any of the following lawyers.

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