Client Alert

April 17, 2017

A Trio of FINRA Notices Focused on Capital Formation Issues

On April 12, 2017, FINRA released three regulatory notices for comment that propose amendments to various FINRA rules affecting capital formation. In connection with its release of the notices, FINRA President and CEO Robert Cook noted FINRA's continuing commitment to assessing its regulations and their role in facilitating capital formation. This initiative is part of the comprehensive self-evaluation and improvement initiative that FINRA announced several months ago called the FINRA 360 initiative. The initiative, FINRA's recent request for comment on its engagement efforts, and these regulatory notices certainly reflect a new tone. In all three notices, as discussed further below, FINRA specifically requests that commenters address the economic impacts of the rules, including costs and benefits, and the specific effects on the capital formation process.

Below we discuss each of the three notices briefly.

Regulatory Notice 17-14

As part of its FINRA 360 initiative, in Regulatory Notice 17-14, FINRA requests comments on various rules relating to capital formation. FINRA notes that there have been significant changes as a result of the JOBS Act, such as changes relating to initial public offerings and private offerings, and the introduction of securities-based crowdfunding and Regulation A. FINRA also notes that in recent years it has introduced modified regulatory frameworks for entities with limited activities, such as the rules for Capital Acquisition Brokers and the Funding Portal Rules. In soliciting comments, the FINRA Notice refers to all capital formation related rules, and specifically identifies the following:

- FINRA Rule 2241 and Rule 2242 relating to equity and debt research analysts and research reports;
- FINRA Rule 2310 relating to public offerings of direct participation programs and unlisted REITs; and
- The FINRA Rule 5100 Series relating to securities offerings, including the rules relating to underwriting terms, offerings of securities with conflicts of interest, private placements, restrictions on the purchase and sale of IPOs, new issue allocations and distributions, sales of securities in a fixed price offering, fairness opinions, disclosure of price and concessions in selling agreements, notification requirements for offering participants, and payments for market making.

FINRA seeks comment on the effectiveness of its rules, costs of compliance, unintended consequences of the rules, and areas in which the rules could be modified in order to promote capital formation without sacrificing investor protection.

Regulatory Notice 17-15

FINRA Rule 5110 (commonly referred to as the Corporate Financing Rule) and certain other FINRA Rules address commercial fairness in underwriting and other arrangements for the distribution of securities. Rule 5110 provides for the review by FINRA of underwriting or other arrangements in connection with most public offerings in order to enable FINRA to assess the fairness and reasonableness of proposed underwriting compensation and arrangements. An offering that is required to be filed with FINRA may not proceed until FINRA has delivered a no-objection letter relating to the underwriting compensation. FINRA Regulatory Notice 17-15 seeks comment on proposed amendments to the Corporate Financing Rule that are characterized by FINRA in its Notice as intended to modernize and simplify the rule based on FINRA's retrospective review of the rule.

The proposed amendments are significant and affect the filing requirements, exemptions from the filing requirements, disclosures, and various other aspects of the rule. The Notice is accompanied by two annexes that include the proposed revised text of the rule (Annex A) and a marked copy (Annex B) showing the proposed changes to the existing rule.

Filing deadline. The proposed rule would allow member firms three business days (instead of one business day) after filing or submission to the Securities and Exchange Commission (the "Commission") or the states of the applicable offering materials to make the requisite FINRA filing. The proposed rule also clarifies that a filing by the member managing the offering relieves the other members of any filing requirement.

Information required to be filed. The proposed rule would clarify which documents are required to be filed and also reduce the number and types of documents required to be filed.

Filing exemptions. The offerings subject to the filing requirements would be all public offerings in which a member participates, subject to certain exceptions.

Certain offerings are not subject to filing, including: securities offered by a bank, corporation, foreign government, or foreign government agency that has unsecured non-convertible debt with a term of at least four years or unsecured non-convertible preferred securities that are investment grade, as well as securities of the same class; investment grade rated non-convertible debt and non-convertible preferred securities; offerings of securities registered on Forms S-3, F-3 or F-10 issued by an "experienced issuer" (as discussed below); investment grade rated financing instrument-backed securities; certain exchange offers; offerings by charitable institutions eligible for the Section 3(a)(4) exemption under the Securities Act; offerings of interests in pooled investment vehicles with a class of securities listed and traded on national securities exchanges that allow for creations/redemptions daily at net asset value; and offerings of certain closed-end fund securities.

The proposed rule would do away with the reference to the 1992 shelf eligibility standard in the existing rule and replace it with the "experienced issuer" standard. An "experienced issuer" is defined as an entity that has a 36-month reporting history preceding the filing of the applicable registration statement, and at least $150 million in non-affiliated float or at least $100 million in non-affiliated float and annual trading volume of three million shares or more.

Certain offerings are not subject to the rule at all, including, but not limited to, offerings exempt under Section 4(a)(1), 4(a)(2), or 4(a)(6) of the Securities Act; offerings made in reliance on Rule 504 if the securities are restricted securities; offerings made in reliance on Rule 506; securities sold in reliance on Rule 144A and Regulation S; and exempted securities under Section 3(a)(12) of the Exchange Act.

Disclosure requirements. The proposed rule would require a description to be included in the plan of distribution section of the offering document that identifies each item of compensation and that addresses the maximum aggregate amount of compensation, as well as the offering document cover page disclosure of the commission or discount to the public offering price together with a cross-reference to the plan of distribution section to the extent that there are other items of compensation. The proposed rule would eliminate the requirement to ascribe a value to each individual item of compensation. The proposal also would clarify the required disclosure of rights of first refusal, securities acquired by member firms, and other similar items.

Underwriting compensation. The proposed rule clarifies that securities acquired in certain transactions are not considered underwriting compensation and are not subject to lock-up requirements, provided that the specified conditions for the applicable exceptions are met. For example, the proposed rule provides for exceptions for securities of the issuer acquired by an affiliate of the member firm in connection with an extension of a credit facility or loan to the issuer, investments in and loans to the issuer made by an affiliate of the member firm, and securities of the issuer purchased in or received as compensation in connection with certain institutional private placements. These exceptions are broader than those currently available under the existing rule and should provide greater flexibility and certainty for venture or private equity private placements. Also, given the increase in the number of private placement transactions, the additional flexibility for private placements with institutional investors should be very well received.

Lock-up restrictions. The proposed rule would add certain exceptions from the 180-day lock-up requirement, such as for securities of an issuer that meets the Form S-3 eligibility requirements and for securities owned on a pro rata basis by equity owners of an investment fund.

Valuation of securities. For purposes of calculating the value of options, warrants, or other convertible securities received as underwriting compensation, the proposed rule would require that the securities be valued using a traditional valuation method that is commercially available and appropriate for the applicable securities, like the Black-Scholes model for options.

Prohibited terms and arrangements. The proposed rule clarifies the list of arrangements that are prohibited.

<u>Regulatory Notice 17-16</u>

FINRA Notice 17-16 seeks comment on proposed amendments to the research rules, Rules 2241 and 2242, which would create a limited safe harbor for desk commentary. The Notice refers to sales material directed to institutional investors based on the observations of sales and trading or principal trading personnel. Generally, this type of commentary is disseminated quickly. FINRA notes that the recipients are institutional investors capable of exercising independent judgment and capable of understanding the potential conflicts of interest that may exist between the trading ideas and recommendations generated by desk personnel and a FINRA member's trading interests. Under the current FINRA research rules, this type of desk commentary might be considered a "research report," which may result in some ambiguity for member firms. For example, FINRA observes that it may be difficult for member firms to draw distinctions among various commentaries and assess whether a particular communication of this type constitutes a research report subject to the restrictions that are imposed by the research rules.

The safe harbor is intended to provide more certainty for communications that meet certain author, content, and recipient conditions, as summarized briefly below.

- *Author*: The commentary must be produced by sales and trading and principal trading personnel who are not primarily engaged in the preparation of research reports that do not meet the safe harbor content limitation, are not required to register as a research analyst, and do not report directly or indirectly to research department personnel;
- *Content*: The commentary must be brief and must not include a rating, price target, or earnings estimate;
- *Recipient*: The commentary may be only be distributed to institutional accounts, and have satisfied the Rule 2111 institutional suitability standard , i.e., certain financial institutions, as well as other investors with at least $50 million in total assets, that have consented (including by negative consent) to receive

desk commentary subject to a transition period during which commentary can be sent to institutional accounts even without negative consent having been obtained; and

- *Conflict management*: Reliance on the proposed safe harbor requires compliance with certain additional provisions of Rule 2241 in order to mitigate potential conflicts of interest, including the establishment, maintenance, and enforcement of written policies and procedures reasonably designed to prevent the use of research reports or research analysts to manipulate the market, prevent the involvement of investment banking personnel, and establish information barriers.

The desk commentary would be required to include a "health warning" disclosure stating that the document was intended for institutional investors, is not subject to all the independence and disclosure standards applicable to research reports prepared for retail investors, and, to the extent applicable, that the document is not independent of the member firm's proprietary interests.

In many respects, the conditions of the proposed safe harbor are similar to, but not the same as, the institutional debt research exemption contained in Rule 2242. The institutional debt exemption includes more onerous consent requirements for smaller institutional investors.

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