

With Proposed Amendments to Rule 5110, FINRA Looks to Modernize Corporate Finance Regulation

The proposal represents a major step in what promises to be a full-scale overhaul of FINRA's Capital Formation Rules

On April 12, 2017, the Financial Industry Regulatory Authority, Inc. (FINRA) published Regulatory Notice 17-15 (RN 17-15), requesting public comment on long-awaited and greatly anticipated proposed revisions to FINRA Rule 5110 (Proposed Rule 5110).¹ The rule proposal is an outgrowth of industry discussions and FINRA's retrospective rule review initiative, which was launched in April 2014 and is intended to ensure that significant FINRA rules are modernized to remain relevant and appropriately designed to achieve their objectives.² RN 17-15 was issued along with a companion Regulatory Notice in which FINRA requests comment more generally on the effectiveness and efficiency of all of its rules and programs governing the capital formation process.³

Background

FINRA Rule 5110 (commonly known as the Corporate Financing Rule) is the principal FINRA rule regulating compensation received by underwriters participating in Public Offerings⁴ of securities. FINRA Rule 5110 prohibits FINRA member firms and their associated persons from participating in any Public Offering of securities if the underwriting terms and conditions, including the amount of compensation to be received, are unfair or unreasonable.⁵ Originally enacted as NASD Rule 2710 in 1992, the rule was substantially updated in 2004, later adopted as FINRA Rule 5110 as part of the rulebook consolidation process in 2008,⁶ and was the subject of more limited revisions as recently as 2014 (Current Rule 5110).⁷ However, the rule has continued to frustrate member firms and other market participants who believe the rule remains overbroad and outdated, often requiring firms to seek interpretive guidance to clarify the intended scope of the rule and waivers of certain provisions to reflect present-day market realities.

Proposed Revisions

Proposed Rule 5110 would make the following revisions:

General Filing Requirements

Filing Period. Proposed Rule 5110 would allow member firms a longer period to make required filings. Currently, any registration statement or amendment that is required to be filed under the rule must be filed within one business day of its confidential submission or filing with the Securities and Exchange Commission (SEC). Recognizing that a longer period would result in a lower error rate without impacting the intended protections of the rule, FINRA has proposed to allow filings to be made within three business days following the SEC filing or confidential submission.⁸

Confidential Submissions. Proposed Rule 5110 now explicitly includes the confidential submission of a registration statement to the SEC as a trigger for the rule's filing requirements.⁹

Filing Exemptions. Proposed Rule 5110 expands and clarifies the types of offerings that are exempt from the filing requirements (but not the substantive requirements) of the rule:¹⁰

- The current exemption from filing for Issuers with outstanding investment grade-rated debt (other than in respect of the Issuer's initial public equity offering) would expressly include Banks.¹¹
- The exemption for offerings by Issuers that meet the so-called "pre-1992" requirements for filing on SEC Forms S-3, F-3 and F-10 (pre-1992 Form S-3 eligible issuers) would be clarified and streamlined by incorporating the historical reporting and public float criteria into a new defined term for Experienced Issuers.¹² By including the criteria for the exemption directly in the rule, FINRA effectively eliminated the need for members to consult decades-old releases and forms in order to determine the applicable eligibility thresholds.¹³ However, this approach may lead to other interpretive questions and calculation issues, given that FINRA does not precisely mirror the SEC's terminology for purposes of determining current Form S-3 eligibility.
- The exemption for exchange offers would be clarified to include securities of a company to be acquired that are listed on any "national securities exchange as defined in Section 6 of the Exchange Act," rather than referencing the more limited and outdated list contained in Current Rule 5110.¹⁴
- A new exemption would be included for certain follow-on offerings by closed-end investment companies operating as "tender offer" funds.¹⁵

Document Filing Requirements

Registration Statement Amendments. FINRA has proposed to modify the filing requirements to require marked pages only when "changes to the offering and the underwriting terms and arrangements" are contained in the amendment.¹⁶ While this modification may prove helpful for certain types of "exhibit only" filings and amendments to update financials, as a practical matter, the inclusion of the broad reference to "changes to the offering" will likely limit the utility of this provision.

Offerings Not Completed According to Their Terms. Proposed Rule 5110 retains Current Rule 5110's prohibition on the receipt of any Underwriting Compensation (other than as permitted under Current Rule 5110(f)(2)(D); Proposed Rule 5110(f)(4)) in connection with a Public Offering that has not been completed according to the terms of an agreement entered into between the Issuer and a Participating Member.¹⁷ However, Proposed Rule 5110 adds a new requirement to file a written notification to FINRA with respect to any Underwriting Compensation permitted under Proposed Rule 5110(f)(4) that is received by a Participating Member in connection with an offering that had been filed with FINRA but was not completed. Any agreement governing such arrangement would also be required to be filed.¹⁸ This new obligation seems unnecessary in light of the strict requirements included in Proposed Rule 511(f)(4) and the explicit documentary filing requirements with respect to the underwriting terms and arrangements under Proposed Rule 5110(a)(4)(A)(ii).

Standard Industry Forms. For offerings that are required to be filed with FINRA pursuant to Proposed Rule 5110(a), FINRA would make explicit the long-standing practice that industry standard master forms of agreement need not be filed unless such agreements are specifically requested by FINRA.¹⁹

Exemptions From Rule Compliance

Proposed Rule 5110 would expand the list of offering types that are completely exempt from compliance with any of the requirements of the rule to include Public Offerings of insurance contracts and unit investment trusts.²⁰

FINRA would also add an express exemption for offerings effected pursuant to Securities Act Rule 144A and Regulation S, which reflects FINRA's long-standing position that such offerings are not considered "offerings to the public" for purposes of the rule and are, therefore, exempted from all requirements of Current Rule 5110.

Disclosure of Underwriting Compensation

Codifying FINRA's current guidance,²¹ Proposed Rule 5110 provides that all items of Underwriting Compensation (other than the discount, which must be separately disclosed) must be individually described in the prospectus, but the value of such items may be aggregated into a single maximum dollar amount for disclosure purposes. Such disclosure must include any rights of first refusal (including the duration of any such right) and securities acquired by member firms that are deemed to be Underwriting Compensation under the rule.²² Members continue to be required to include a footnote to the discount table of the prospectus on the cover page cross-referencing the "Plan of Distribution" section. The current requirement to disclose each item of Underwriting Compensation along with its value in the FINRA filing itself also remains unchanged.

Underwriting Compensation

Determining what does and does not qualify as Underwriting Compensation has challenged member firms and their counsel since the original enactment of NASD Rule 2710. With this revision, FINRA hopes to substantially simplify this analysis by removing certain items from the definition of Underwriting Compensation entirely and bringing in a market-based solution for valuing options and convertible securities received by Participating Members during the Review Period.²³

Items of Value. Proposed Rule 5110 removes the old term "items of value"²⁴ and includes, under a new umbrella definition of Underwriting Compensation, "any payment, right, interest or benefit received or to be received by a participating member from any source," including any "finder fees, and underwriter's counsel fees, including expense reimbursements and securities."²⁵ The reference to "finder fees, and underwriter's counsel fees, including expense reimbursements and securities" is seemingly duplicative and unnecessary, as these items are expressly included in the Supplementary Material (as further discussed below) as examples of Underwriting Compensation, and also potentially problematic to the extent the reference implies that such items as finder fees and underwriter's counsel fees are counted as Underwriting Compensation, even if they are paid out-of-pocket by the Participating Members and not reimbursed by the Issuer.

Expanding on the definition of Underwriting Compensation, FINRA continues to provide non-exhaustive lists of those items it deems to be Underwriting Compensation and those excluded from such characterization. These lists are now helpfully included in Supplementary Materials .01(a) and (b), respectively.²⁶ The list of items deemed to be Underwriting Compensation under .01(a) includes some useful clarifications but otherwise remains largely unchanged from the list set forth in Current Rule 5110(c)(3)(A). Importantly, however, Proposed Rule 5110 provides that the inclusion in Underwriting Compensation of securities received by Participating Members during the Review Period is expressly limited to those securities "beneficially owned" (as such term is defined in FINRA Rule 5121) by such members.

The non-exhaustive list of items excluded from the definition of Underwriting Compensation has been expanded and largely rewritten. Notably, the list now includes certain securities that are subject to the exemptions provided by Current Rule 5110(d)(5)(D) and (E). Consistent with the current exemption requirements, the FINRA member must have acquired its original interest in the subject securities prior to the Review Period applicable to the offering and any securities acquired during the Review Period must be acquired as a result of a stock split, conversion, right of preemption or certain other acquisitions to prevent dilution. By including these types of securities acquisitions on the list of items that are not deemed to be Underwriting Compensation, FINRA members would no longer be required to make any representations to FINRA with respect to such acquisitions.²⁷ Additionally, these securities would not be subject to the rule's lock-up provisions.²⁸

Non-Cash Compensation. The current provisions governing the receipt by a Participating Member of any Non-Cash Compensation have been retained in full in Proposed Rule 5110.²⁹ FINRA notes that these provisions have not been modified here since they are the subject of a separate review proposing a consolidated approach to FINRA's Non-Cash Compensation rules more generally.³⁰ However, the impact of these provisions in the context of this rule requires FINRA's immediate attention. In particular, if applied literally, the Non-Cash Compensation provisions state that members may not receive any Non-Cash Compensation other than those limited items set forth in the provision itself, and those items do not include certain common forms of non-cash consideration such as securities, derivative instruments or rights of first refusal that are elsewhere in the rule expressly permitted. This inherent conflict should not be deferred until the completion of the general retrospective review of the Non-Cash Compensation provisions, but instead should be addressed in these Rule 5110 amendments.

Venture Capital Exemptions. The three so-called "venture capital" exemptions listed under "Securities Acquisitions Not Considered Underwriting Compensation" in Current Rule 5110³¹ have been retained with some significant changes.³² FINRA has removed the requirement that "all entities related to each member in acquisitions that qualify for this exception do not acquire more than 25% of the Issuer's total equity securities, calculated immediately following the transaction" from the "Purchases and Loans by Certain Affiliates" and "Investments in and Loans to Certain Issuers" exemptions. According to FINRA, the 25% threshold had been added in 2004 in order to respond to market conditions following the tech bubble and to "distinguish securities acquired in bona fide venture capital transactions from those acquired as Underwriting Compensation."³³ However, FINRA has since determined that current applicable regulations have provisions better suited to "address acquisitions that create control relationships,"³⁴ making these thresholds no longer necessary.

With respect to the exemption for "Private Placements With Institutional Investors,"³⁵ FINRA has increased the aggregate allowable acquisition threshold for Participating Member firms from 20% to 40% of the total offering. Since Issuers generally conduct private placements prior to knowing the syndicate members for a potential Public Offering, FINRA has concluded that the old threshold unnecessarily limited member firms from being able to participate in both the private placement and the Public Offering, to the detriment of Issuers. According to FINRA, increasing this threshold to 40% would allow a greater number of member firms to participate to the benefit of Issuers without "materially changing the operation of the exception."³⁶

Valuation of Convertible Securities

Warrants, options, and convertible or exchangeable debt securities are all still included in the list of "payments or benefits that are considered Underwriting Compensation" in Supplementary Materials .01.³⁷ However, Proposed Rule 5110 provides that such securities may now be valued in accordance with a "securities valuation method that is commercially available and appropriate for the type of securities to be

valued (e.g., the Black-Scholes model for options)” instead of the formula FINRA currently provides.³⁸ A written description of such methodology must also be filed with FINRA pursuant to Proposed Rule 5110(a)(4)(B)(iii). FINRA believes that this change will result in a more “commercially reasonable valuation,” for the benefit of both Issuers and the public, while reducing administrative costs for FINRA and its member firms.³⁹

Lock-Up Restrictions

Application of Lock-Up Restrictions. Proposed Rule 5110 clarifies that the 180-day lock-up period set forth in the rule begins with the initiation of sales in the offering and not on the date of effectiveness of the registration statement. Notably, however, the lock-up restrictions of Proposed Rule 5110 would also be revised to cover all Public Offerings and all securities-based Underwriting Compensation. In contrast, the lock-up restrictions of Current Rule 5110 apply only in connection with “public equity offerings” and only to equity and equity-linked securities (other than those of Experienced Issuers) “that are unregistered and acquired by an underwriter and related person during 180 days prior to the required filing date, or acquired after the required filing date of the registration statement and deemed to be underwriting compensation by FINRA and securities excluded from underwriting compensation pursuant to paragraph (d)(5)(A), (B), (C) and (E).”⁴⁰ This proposed change should be further clarified as it would appear to expand the scope of offerings and securities potentially subject to the lock-up (including in respect of non-convertible and non-exchangeable debt securities or derivative instruments acquired at a “fair price” in a transaction related to the offering, as well as to securities of an Issuer acquired in a public market transaction by a Participating Member during the Review Period if such securities are not listed on a National Securities Exchange or are not issued by a current Form S-3 eligible issuer, as defined below).

Exemption from Lock-Up Restrictions. Proposed Rule 5110 includes an exemption from the lock-up restrictions for all securities issued by an Issuer that meets the current requirements to file offerings on Form S-3, F-3 or F-10 (a current Form S-3 eligible issuer).⁴¹ The exemption in Current Rule 5110 is, as noted above, limited to pre-1992 Form S-3 eligible issuers (now defined as Experienced Issuers).⁴²

Permitted Transfers. Proposed Rule 5110 would also permit (i) transfers of securities subject to the lock-up restriction to other FINRA members participating in the offering or to its officers or partners, registered persons or affiliates, so long as the securities continue to be locked-up for the remainder of the required period⁴³ and (ii) transfers or sales of locked-up securities back to the Issuer of the securities in a transaction exempt from SEC registration.⁴⁴

Definitions

Proposed Rule 5110 consolidates all of the definitions from the rule (other than those set forth in the Non-Cash Compensation provisions) into a single section and moves them to the end of the rule for ease of reference.

New Definitions. In addition to the new Experienced Issuer and Underwriting Compensation definitions described above, FINRA has added definitions for Review Period,⁴⁵ Independent Financial Adviser,⁴⁶ Overallotment Option⁴⁷ and Public Offering.⁴⁸

Review Period: This new definition clarifies and codifies the periods essential for determining which payments, rights, interests or other benefits are required to be included as Underwriting Compensation for an offering. In particular, the duration of the “Review Period” in the new definition varies depending on the type of offering:

- Firm commitment offerings have a Review Period beginning 180 days prior to the Required Filing Date⁴⁹ for the offering through 60 days after pricing.
- Best efforts offerings have a Review Period beginning 180 days prior to the Required Filing Date through 60 days following the final closing.
- For either a firm commitment or a best efforts takedown offering under a shelf registration statement, the definition of Review Period clarifies and codifies the current understanding that the period begins 180 days prior to the Required Filing Date of the takedown and continues through to the 60th day following the final closing of the takedown.

Public Offering: Proposed Rule 5110(i)(18) would define a Public Offering as “any primary or secondary offering of securities made pursuant to a registration statement, offering circular or similar offering document including exchange offers, rights offerings, and offerings of securities made pursuant to a merger or acquisition.” FINRA stated that adding the definition to Proposed Rule 5110 will allow it to delete the corresponding definition from FINRA Rule 5121⁵⁰ and incorporate all of the FINRA Rule 5110 definitions into FINRA Rule 5121 by reference.

However, in transferring this definition from FINRA Rule 5121 to Proposed Rule 5110, FINRA has deleted the exceptions to the definition for offerings of exempted securities as defined in Section 3(a)(12) of the Securities Exchange Act of 1934 and offerings made pursuant to (i) Securities Act Sections 4(a)(1), 4(a)(2), or 4(a)(6), (ii) Securities Act Rules 504 (if the securities are “restricted securities” under Securities Act Rule 144(a)(3)), 505 and 506, and (iii) Securities Act Rule 144A or SEC Regulation S, and instead included these types of offerings as exceptions to compliance with the requirements of Proposed Rule 5110.

As a result, not only is the definition of “Public Offering” confusing and over-broad, but it appears the conflict of interest provisions of FINRA Rule 5121 (including the requirement to appoint a “qualified independent underwriter” in certain cases) would now apply to the aforementioned offering types (*i.e.*, to private placements, Rule 144A offerings, Regulation S offerings and offerings of exempted securities), which presumably is an unintended consequence of FINRA’s consolidation effort.

Independent Financial Adviser: FINRA has added a new standalone definition for Independent Financial Adviser. In Current Rule 5110, the definition was housed as a carve-out to the definition for Participation or Participating in a Public Offering. The definition also has had some minor updates that codify the operation of this provision under Current Rule 5110.

Modified Definitions. The definition of Issuer has been narrowed slightly with the removal of “employees and security holders of the Issuer,” but nonetheless remains quite broad. The definition of Participating Member⁵¹ has also been revised to expressly exclude the Issuer and thus avoid overlap in circumstances in which the Issuer is an affiliate of a Participating Member.

Retired Definition. Proposed Rule 5110 would remove the definition of “Underwriter and Related Persons”⁵² in its entirety. FINRA deleted this definition in order to “provide greater clarity and consistency on the scope of persons covered” in the rule.⁵³ FINRA believes that the combination of the definition of Participating Member with the new definition of Underwriting Compensation along with the Supplementary Materials will adequately capture any “fees and expenses paid to persons previously covered by the Underwriter and Related Persons definition.”⁵⁴ This is a useful and important change, but the definition of Participating Member is still quite broad and continues to include all associated persons of the member,

including those having no ability to control the member and having nothing to do with the particular offering in question.

Conclusion

From an organizational perspective, Proposed Rule 5110 is a significant rewrite. However, while the changes are largely helpful, there remain certain areas that warrant further clarification, revision and guidance.

FINRA has requested detailed comments on Proposed Rule 5110 by May 30, 2017. In addition to general comments and feedback on the Underwriting Compensation exemptions and the valuation of convertible securities, FINRA has requested comment with respect to any impact Proposed Rule 5110 would have on offerings pursuant to Regulation A+ and any improvements to FINRA's regulatory oversight in that area. FINRA is also soliciting comments with respect to the expected economic impact of the proposed revisions, as well as suggestions as to any alternative approaches that should be considered.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

[Dana G. Fleischman](#)

dana.fleischman@lw.com
+1.212.906.1220
New York

[Stephen P. Wink](#)

stephen.wink@lw.com
+1.212.906.1229
New York

[Ellen M. Creede](#)

ellen.creede@lw.com
+1.212.906.1757
New York

[Gail S. Neely](#)

gail.neely@lw.com
+1.212.906.4578
New York

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Endnotes

¹ FINRA Regulatory Notice 17-15 (April 2017), available at http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-15.pdf. See also Attachment A to RN 17-15, available at http://www.finra.org/sites/default/files/Reg-Notice_5110-Rule-Text-Attachment-A.pdf and Attachment B to RN 17-15, available at http://www.finra.org/sites/default/files/Reg-Notice_5110-Rule-Text-Attachment-B.pdf.

² See FINRA Special Notice (March 21, 2017), available at http://www.finra.org/sites/default/files/notice_doc_file_ref/Special-Notice-032117.pdf, in which FINRA discusses its "FINRA360" initiative and requests comment on FINRA's current engagement programs pursuant to which FINRA interacts with member firms, investors and other stakeholders regarding its various rules and the rulemaking process in general. Among the engagement programs is interaction with the industry through various

advisory committees, including the Corporate Financing Committee, which regularly advises on issues arising from member firms' capital-raising activities. FINRA has extended the comment period in respect of the Special Notice from May 5 to June 19, 2017.

- ³ See FINRA Regulatory Notice 17-14 (April 2017), available at http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-14.pdf. Comments in respect of such notice are due May 30, 2017.
- ⁴ For ease of reference, this *Client Alert* capitalizes certain terms defined (without capitalization) in Proposed Rule 5110. To the extent not otherwise defined herein, such terms have the meanings ascribed to them in Proposed Rule 5110(i).
- ⁵ Current Rule 5110(f).
- ⁶ FINRA Rule 5110, as adopted in 2008, was essentially the same as prior NASD Rule 2710 with the exception of two provisions relating to compliance with SEC Regulation M, which were relocated to new FINRA Rule 5190.
- ⁷ See *Client Alert* "[SEC Approves Significant Amendments to FINRA Rules 5110 and 5121](#)" Number 1689, dated May 22, 2014.
- ⁸ RN 17-15 at p. 3.
- ⁹ Proposed Rule 5110(a)(3)(A)(i)(a).
- ¹⁰ Proposed Rule 5110(g)(1).
- ¹¹ Proposed Rule 5110(g)(1)(A).
- ¹² Proposed Rule 5110(i)(6). The term Experienced Issuer would mean an entity with 36 calendar months reporting history preceding the filing of the registration statement and either (i) a minimum of \$150 million aggregate market value of voting stock held by non-affiliates or (ii) a minimum of \$100 million aggregate market value of voting stock held by non-affiliates and a minimum annual trading volume of such stock of three million shares (mirroring the thresholds for eligibility to file on SEC Form S-3 that existed prior to October 21, 1992).
- ¹³ See, e.g., FINRA (then NASD) Notice to Members 93-88, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1551.
- ¹⁴ Proposed Rule 5110(g)(1)(E). Note that this definition is also included in Supplementary Material .01(c)(1). Current Rule 5110 includes only the New York Stock Exchange, the Nasdaq Global Market and the American Stock Exchange.
- ¹⁵ Proposed Rule 5110(g)(1)(H).
- ¹⁶ Proposed Rule 5110(a)(4)(A)(iii).
- ¹⁷ Current Rule 5110(f)(2)(D); Proposed Rule 5110(f)(4).
- ¹⁸ Proposed Rule 5110(a)(4)(C).
- ¹⁹ Proposed Rule 5110(a)(4)(A)(ii).
- ²⁰ Proposed Rule 5110(g)(2). FINRA's rationale for exempting insurance contracts and unit investment trusts is that they are regulated sufficiently by FINRA Rule 2341 and the Investment Company Act. See RN 17-15 at p. 4 and p. 10.
- ²¹ See "Corporate Financing Rule-Disclosure Requirements" FAQ included with the "Public Offering Frequently Asked Questions (FAQ)" available at <http://www.finra.org/industry/faq-public-offering-frequently-asked-questions-faq> (first published January 2012).
- ²² Proposed Rule 5110(b) and Supplementary Materials .03.
- ²³ Proposed Rule 5110(i)(22) and Supplementary Materials .01 and .02.
- ²⁴ Current Rule 5110(c)(3).
- ²⁵ Proposed Rule 5110(i)(22) and Supplementary Materials .01.
- ²⁶ Proposed Rule 5110 Supplementary Materials.
- ²⁷ Proposed Rule 5110 Supplementary Materials .01(b)(14)-(18).
- ²⁸ Currently, only securities acquisitions under Rule 5110(d)(5)(D) are exempt from the lock-up requirements.
- ²⁹ Proposed Rule 5110(e); Current Rule 5110(h).
- ³⁰ See RN 17-15 at n. 7, referencing FINRA Regulatory Notice 16-29 (August 2016).
- ³¹ Current Rule 5110(d)(5)(A)-(C).
- ³² Proposed Rule 5110(c)(1)-(3).
- ³³ RN 17-15 at p. 6.
- ³⁴ RN 17-15 at p. 6.
- ³⁵ Current Rule 5110(d)(5)(C); Proposed Rule 5110(c)(3).
- ³⁶ RN 17-15 at p. 6.
- ³⁷ Proposed Rule 5110 Supplementary Materials .01(a)(7).
- ³⁸ RN 17-15 at p. 7 and Supplementary Material .02 "Valuation of Underwriting Compensation." See also Current Rule 5110(e)(3).

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- ³⁹ RN 17-15 at p. 7.
- ⁴⁰ Current Rule 5110(g)(1).
- ⁴¹ Proposed Rule 5110(d)(2)(A)(iii).
- ⁴² Current Rule 5110(g)(1), referencing (b)(7)(C)(i) and (ii).
- ⁴³ Proposed Rule 5110(d)(2)(B)(i).
- ⁴⁴ Proposed Rule 5110(d)(2)(B)(iii).
- ⁴⁵ Proposed Rule 5110(i)(20).
- ⁴⁶ Proposed Rule 5110(i)(9).
- ⁴⁷ Proposed Rule 5110(i)(14).
- ⁴⁸ Proposed Rule 5110(i)(18).
- ⁴⁹ Proposed Rule 5110(i)(19).
- ⁵⁰ FINRA has included this definitional change to Rule 5121 in the proposed amended rule language included in Attachments A and B to RN 17-15.
- ⁵¹ Proposed Rule 5110(i)(15).
- ⁵² Current Rule 5110(a)(6).
- ⁵³ RN 17-15 at p. 8.
- ⁵⁴ RN 17-15 at p. 8.