

Cover Your Backside: FINRA Proposes To Allow Tail Fees and ROFRs

FINRA recently issued [Regulatory Notice 12-27](#) regarding proposed amendments (the “**Proposed Amendments**”) to FINRA Rule 5110 (the “**Corporate Financing Rule**”). Provided that certain criteria are satisfied, the Proposed Amendments would afford issuers and investment banks with greater flexibility to use termination fees (“**Tail Fees**”) and/or rights of first refusal (“**ROFRs**”) in structuring and negotiating engagement letters and underwriting and financial advisory services.

What Is The Corporate Financing Rule?

The Corporate Financing Rule requires that member firms file with FINRA’s Corporate Financing Department documents and information, including engagement letters, regarding the underwriting arrangements in public securities offerings in which member firms participate. Through the Corporate Financing Rule, FINRA regulates the commercial reasonableness and fairness of underwriting compensation and arrangements in such offerings.

What Are Tail Fees And ROFRs?

In connection with securities offerings, investment banks typically enter into engagement letters with issuers for underwriting and financial advisory services. Concerned that up-front payment for such services could adversely affect their finances and cash flows, issuers often seek to include in engagement letters provisions that allow the deferral of payment until after the completion of the offering (a “**Deferred Compensation Arrangement**”). Conversely, to hedge against the possibility that an issuer that has received underwriting and financial advisory services might unreasonably cancel an engagement to avoid payment under a Deferred Compensation Arrangement, underwriters frequently seek to include in engagement letters provisions that provide for Tail Fees and/or ROFRs. Tail Fees permit an underwriter to receive fees if its underwriting and financial advisory services are terminated, and the issuer consummates an offering with another underwriter in lieu of the offering which is the subject of the engagement letter. ROFRs provide underwriters with the first opportunity to underwrite a subsequent offering if the original offering is abandoned. Although Tail Fees and ROFRs provide issuers and underwriters with greater flexibility in structuring and negotiating engagement letters and underwriting and financial advisory services, FINRA does not generally favor Tail Fees and ROFRs and has historically limited their usage.

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What Do The Proposed Amendments Provide?

Because FINRA is concerned that the current restrictions on the use of Tail Fees and ROFRs may unnecessarily interfere with the ability of issuers and underwriters to utilize Deferred Compensation Arrangements that are fair and reasonable, the Proposed Amendments allow Tail Fees and ROFRs when an engagement letter specifies that:

- the amount of the Tail Fee must be reasonable in relation to the services contemplated in the engagement letter, and fees arising from services provided in connection with a ROFR must be customary for such services;
- the issuer has a right of “termination for cause” which includes the member firm’s material failure to provide the services contemplated in the engagement letter; and
- an issuer’s “termination for cause” eliminates any obligations with respect to any Tail Fee or ROFR.
- The Proposed Amendments would retain the requirements in the current Corporate Financing Rule that:
- Tail Fees can only be paid if the offering or other transaction contemplated in the engagement letter is consummated within two years of the date that the engagement letter is terminated; and
- ROFRs are prohibited if they have a duration of more than three years from the date of effectiveness or commencement of sales in a public offering of securities.
- These retained requirements are designed to ensure that issuers are not subject to a Tail Fee or ROFR even after their businesses and operations may have significantly changed over time.

Do The Proposed Amendments Contemplate FINRA’s New Public Offering System?

Yes. The Proposed Amendments make certain ministerial changes to the Corporate Financing Rule that, among other things, would require that filings made pursuant to the Corporate Financing Rule must be made through the Public Offering System. Additionally, any filings made through the Public Offering System in accordance with the Corporate Financing Rule will be subject to FINRA’s increased filing fees (up to a new maximum of \$225,500 commencing on July 2, 2012).

When Are Comments Due?

Comments regarding the Proposed Amendments are due by July 23, 2012 and may be [emailed](#) to FINRA.

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