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Legal Update

Corporate Financing Rule Change (FINRA Rule 5110)

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently released Regulatory Notice 20-10, which discusses the recent changes to Rule 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements) (the "Rule"), the main FINRA rule regarding the reasonableness of compensation paid to FINRA member firms in securities offerings.

The revised Rule will be implemented in two parts. Amended Rule 5110(a)(3)(A) (regarding filing deadlines) and Rule 5110(a)(4)(A)(ii-iii) (regarding documents required to be filed) are currently in effect as of March 20, 2020. The remaining revised provisions will be implemented on September 16, 2020.

General Filing Requirements

Filing deadline. The amended Rule allows FINRA member firms three business days (previously one business day) from the time of filing with the Securities and Exchange Commission ("SEC") or applicable state regulatory authority to complete the required FINRA filing. In addition, the amended Rule clarifies various aspects of Rule 5110, 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 amended Rule clarifies and simplifies the documentation and information filing requirements. The Rule limits when industry standard master forms, like master agreements among underwriters (only when specifically requested by FINRA) 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 ten percent or more (previously five percent) 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. Member firms are also directed to include SEC document identification numbers in applicable FINRA filings.

Filing Requirements for Shelf Offerings

Exempt shelf offerings. The amended 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 amended 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

Rule 5110 includes two categories of exempt public offerings – those that are exempt from both filing and substantive requirements and those that are exempt from the filing requirements while remaining subject to the substantive provisions of the Rule.

Filing exemption. The revised Rule clarifies, consistent with existing interpretation, that the exemption for corporate issuers with outstanding debt securities includes banks and, based on the new definition of "bank," explicitly includes foreign banks and branches or agencies of a foreign bank that are supervised and examined by a federal or state banking authority. The investment grade debt exemption has also been modified to reflect that it is only meant to apply where the qualifying securities are currently outstanding.

Filing and substantive exemption. The amended Rule expands the list of exempt offerings to include public offerings of closed-end "tender offer" funds, insurance contracts, unit investment trusts and issuer self-tenders.

In addition, the amended 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.

Underwriting Compensation

Underwriting compensation defined. The amended 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 amended 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 existing 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 amended 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 amended Rule modifies, clarifies and expands the current venture capital exceptions from underwriting compensation in order to facilitate participation by affiliates of member firms 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 revised Rule, and two additional exceptions under the existing Rule are modified by the amended 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 amended Rule expands the scope of the parties that 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 amended Rule. Securities acquired by a participating FINRA member firm in a private placement before the required filing date of the public offering 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 are open-end investment companies not traded on an exchange and no such entity is an affiliate of a FINRA member firm participating in the offering.

Delayed offerings. The amended Rule change also seeks to provide additional flexibility to rely on the venture capital exceptions where a 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 for the venture capital exception, should be considered underwriting compensation.

Non-Convertible or Non-Exchangeable Debt Securities and Derivatives

As underwriting compensation. The amended 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 amended 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 revised Rule.

Lock-up Restrictions

The amended 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 revised 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;
- Securities that are "actively traded securities" (as defined in Regulation M);
- Derivative instruments that are acquired at a fair price as part of hedging transactions;
- 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 amended 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 amended Rule consolidates all of the definitions into a single section and makes the terminology more consistent throughout the Rule's various provisions.

Regulatory Notice 20-10 is available here.

The full text of the revised Rule is available here.

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

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