

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-86509; File No. SR-FINRA-2019-012)

July 29, 2019

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Instituting Proceedings to Determine Whether to Approve or Disapprove Proposed Rule Change to Amend FINRA Rule 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements) to Make Substantive, Organizational and Terminology Changes

I. Introduction

On April 11, 2019, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend FINRA Rule 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements) (“Rule” or Rule 5110) to make substantive, organizational and terminology changes to the Rule.

The proposed rule change was published for comment in the Federal Register on May 1, 2019.<sup>3</sup> On June 12, 2019, the Commission extended to July 30, 2019, the time period in which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change.<sup>4</sup> The Commission received six comment letters on the proposal.<sup>5</sup>

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 85715 (April 25, 2019), 84 FR 18592 (May 1, 2019) (“Notice”).

<sup>4</sup> See Securities Exchange Act Release No. 34-86091 (June 12, 2019), 84 FR 28371 (June 18, 2019).

<sup>5</sup> See Letter from Suzanne Rothwell, Managing Member, Rothwell Consulting LLC, to Secretary, Commission, dated May 14, 2019 (“Rothwell”); letter from Stuart J. Kaswell, Esq., to Vanessa Countryman, Acting Director, Commission, dated May 17, 2019

On July 11, 2019, FINRA responded to the comments and filed Partial Amendment No. 1 to the proposal.<sup>6</sup> The Commission is publishing this notice and order to solicit comments on the proposal as modified by Partial Amendment No. 1 from interested persons and to institute proceedings pursuant to Exchange Act Section 19(b)(2)(B)<sup>7</sup> to determine whether to approve or disapprove the proposed rule change, as modified by Partial Amendment No. 1.

Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to the proposed rule change, nor does it mean that the Commission will ultimately disapprove the proposed rule change. Rather, as discussed below, the Commission seeks additional input on the proposed rule change, as modified by Partial Amendment No. 1, and on the issues presented by the proposal.

## II. Description of the Proposed Rule Change

### A. Proposed Rule Change as Originally Filed

The following is a summary of the proposed rule change as originally filed by FINRA.<sup>8</sup>

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(“Kaswell”); letter from Eversheds Sutherland (US) LLP, on behalf of the Committee of Annuity Insurers, to Brent J. Fields, Secretary, Commission, dated May 21, 2019 (“CAI”); letter from Aseel Rabie, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, to Vanessa Countryman, Acting Secretary, Commission, dated May 30, 2019 (“SIFMA”); letter from Robert E. Buckholz, Chair, Federal Regulation of Securities Committee, ABA Business Law Section, American Bar Association, to Vanessa Countryman, Acting Secretary, Commission, dated May 30, 2019 (“ABA”); letter from Davis Polk & Wardwell LLP, to Vanessa Countryman, Acting Secretary, Commission, dated June 5, 2019 (“Davis Polk”).

<sup>6</sup> See Letter from Jeanette Wingler, Associate General Counsel, FINRA, to Vanessa Countryman, Secretary, Commission, dated July 11, 2019 (“FINRA Response”). Partial Amendment No. 1 and FINRA’s response to comments received are available at <https://www.finra.org/industry/rule-filings/sr-finra-2019-012>. See also Section II.B *infra*.

<sup>7</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>8</sup> See Notice, *supra* note 3, for a complete description of the proposal as originally filed.

As described in more detail in the Notice, FINRA proposes to modify Rule 5110 in an effort to modernize, simplify, and streamline the Rule. Specifically, FINRA proposes changes to the following: (1) filing requirements; (2) filing requirements for shelf offerings; (3) exemptions from filing and substantive requirements; (4) underwriting compensation; (5) venture capital exceptions; (6) treatment of non-convertible or non-exchangeable debt securities and derivatives; (7) lock-up restrictions; (8) prohibited terms and arrangements; and (9) defined terms.<sup>9</sup> FINRA believes that these changes should lessen the regulatory costs and burdens incurred when complying with the Rule.

### Filing Requirements

FINRA proposes to allow members more time to make the required filings with FINRA from one business day after filing with the SEC or a state securities commission or similar state regulatory authority to three business days.<sup>10</sup>

FINRA also proposes to clarify and reduce filing requirements by directing members to provide SEC document identification number if available.<sup>11</sup> FINRA also proposes to require filing: (1) industry-standard master forms of agreement only if specifically requested to do so by FINRA;<sup>12</sup> (2) amendments to previously filed documents only if there have been changes

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<sup>9</sup> As discussed below, the proposal retains the current approach to itemized disclosure of underwriting compensation, but makes explicit the existing practice of disclosing specified material terms and arrangements related to underwriting compensation, such as exercise terms, in the prospectus. In addition, the proposed rule change does not include any changes to current Rule 5110(h) (Non-Cash Compensation). According to FINRA, these provisions are the subject of a separate consolidated approach to non-cash compensation. See Regulatory Notice 16-29 (August 2016).

<sup>10</sup> See proposed Rule 5110(a)(3)(A).

<sup>11</sup> See proposed Rule 5110(a)(4)(A).

<sup>12</sup> See proposed Rule 5110(a)(4)(A)(ii).

relating to the disclosures that impact the underwriting terms and arrangements for the public offering in those documents;<sup>13</sup> (3) a representation as to whether any associated person or affiliate of a participating member is a beneficial owner of 5% or more of “equity and equity-linked securities”;<sup>14</sup> and (4) an estimate of the maximum value for each item of underwriting compensation.<sup>15</sup>

FINRA also proposes to make a number of other clarifications regarding filing requirements to FINRA and filing requirements of specific members participating in the public offering.<sup>16</sup>

FINRA proposes to adopt a new provision addressing terminated offerings, which provides that, when an offering is not completed according to the terms of an agreement entered into by the issuer and a member, but the member has received underwriting compensation, the member must give written notification to FINRA of all underwriting compensation received or to be received, including a copy of any agreement governing the arrangement.<sup>17</sup>

#### Filing Requirements for Shelf Offerings

FINRA proposes to codify exemptions from the filing requirements for certain shelf offerings that have historically been exempt from Rule 5110 and to streamline the filing requirements for the remaining shelf offerings.<sup>18</sup>

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<sup>13</sup> See proposed Rule 5110(a)(4)(A)(iii).

<sup>14</sup> See proposed Rule 5110(a)(4)(B)(iii) and proposed Rule 5110(j)(7).

<sup>15</sup> See proposed Rule 5110(a)(4)(B)(ii).

<sup>16</sup> See proposed Rule 5110(a)(3)(B), 5110(a)(2), 5110(a)(1)(C), and 5110(a)(1)(B). See also Notice, supra note 3, 84 FR at 18593.

<sup>17</sup> See proposed Rule 5110(a)(4)(C) and proposed Rule 5110(g)(5).

<sup>18</sup> See Notice, supra note 3, 84 FR at 189593-594.

## Public Offerings Exempt from the Filing Requirement

FINRA proposes to expand and clarify the scope of the exemptions under current Rule 5110. For example, FINRA proposes to exempt from Rule 5110's filing requirement a public offering by an "experienced issuer."<sup>19</sup> Although the proposed rule change would continue to apply Rule 5110's filing requirement to shelf offerings by issuers that do not meet the "experienced issuer" standard, such issuer would only need to file the following: (1) the Securities Act of 1933 ("Securities Act") registration statement number; and (2) if specifically requested by FINRA, other documents and information set forth in Rule 5110(a)(4)(A) and (B).<sup>20</sup> FINRA also proposes to clarify that securities of banks that have qualifying outstanding debt securities are exempt from the filing requirement.<sup>21</sup>

FINRA proposes to expand the current list of offerings that are exempt from both the filing requirements and substantive provisions of Rule 5110 to include public offerings of closed-end "tender offer" funds (i.e., closed-end funds that repurchase shares from shareholders pursuant to tender offers), insurance contracts and unit investment trusts.<sup>22</sup> In addition, the proposed rule change reclassifies three items from the offerings exempt from filing and rule compliance to offerings excluded from the definition of public offering. The three items are: (1)

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<sup>19</sup> The proposed rule change would delete references to the pre-1992 standards for Form S-3 and standards approved in 1991 for Form F-10 and instead codify the requirement that the issuer have a 36-month reporting history and at least \$150 million aggregate market value of voting stock held by non-affiliates or alternatively the aggregate market value of voting stock held by non-affiliates is at least \$100 million and the issuer has an annual trading volume of three million shares or more in the stock. See proposed Rule 5110(j)(6) and Notice, supra note 3.

<sup>20</sup> See proposed Rule 5110(a)(4)(E).

<sup>21</sup> See proposed Rule 5110(h)(1)(A).

<sup>22</sup> See proposed Rule 5110(h)(2)(E), (K) and (L).

offerings exempt from registration with the SEC pursuant to Section 4(a)(1), (2) and (6) of the Securities Act; (2) offerings exempt from registration under specified Regulation D provisions; and (3) offerings of exempted securities as defined in Section 3(a)(12) of the Exchange Act.

#### Disclosure Requirements

FINRA states that the proposed rule change would retain the current requirements for itemized disclosure of underwriting compensation and disclosing dollar amounts ascribed to each such item.<sup>23</sup> FINRA also proposes to incorporate into proposed Supplementary Material .05 to Rule 5110 the requirements for disclosure of specified material terms and arrangements that it believes are consistent with current practice.<sup>24</sup> Further, the proposal makes explicit the existing practice of disclosing specified material terms and arrangements related to underwriting compensation in the prospectus, and requires a description for: (1) any right of first refusal (“ROFR”) granted to a participating member and its duration; and (2) the material terms and arrangements of the securities acquired by the participating member (e.g., exercise terms, demand rights, piggyback registration rights and lock-up periods).<sup>25</sup>

#### Underwriting Compensation

FINRA proposes to define the term “Underwriting Compensation” in proposed Rule 5110 to mean “any payment, right, interest, or benefit received or to be received by a participating member from any source for underwriting, allocation, distribution, advisory and other investment banking services in connection with a public offering. In addition,

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<sup>23</sup> See proposed Rule 5110(b)(1) and Supplementary Material .05 to Rule 5110. See also proposed Rule 5110(e)(1)(B) requiring disclosure of lock-ups.

<sup>24</sup> See proposed Supplementary Material .05 to Rule 5110.

<sup>25</sup> See proposed Supplementary Material .05 to Rule 5110.

underwriting compensation shall include finder's fees, underwriter's counsel fees and securities."<sup>26</sup>

Rule 5110 currently provides that all items of value received or to be received from any source are presumed to be underwriting compensation when received during the period commencing 180 days before the required filing date of the registration statement, and up to 90 days following the effectiveness or commencement of sales of a public offering. FINRA states that, to better reflect the different types of offerings subject to the Rule, the proposed rule change would introduce the defined term "review period", and that the applicable time period would vary based on the type of offering. The proposed rule change would define the term "review period" to mean: (1) for a firm commitment offering, the 180-day period preceding the required filing date through the 60-day period following the effective date of the offering; (2) for a best efforts offering, the 180-day period preceding the required filing date through the 60-day period following the final closing of the offering; and (3) for a firm commitment or best efforts takedown or any other continuous offering made pursuant to Rule 415 of the Securities Act, the 180-day period preceding the required filing date of the takedown or continuous offering through the 60-day period following the final closing of the takedown or continuous offering.<sup>27</sup>

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<sup>26</sup> See proposed Rule 5110(j)(22).

<sup>27</sup> See proposed Rule 5110(j)(20). FINRA states that, in accordance with this proposal, payments and benefits received during the applicable review period would be considered in evaluating underwriting compensation.

The proposed rule change would continue to provide two non-exhaustive lists of examples of payments or benefits that would and would not be considered underwriting compensation, with streamlining and clarifying modifications.<sup>28</sup>

In addition, the proposed rule change would take a principles-based approach in considering whether issuer securities acquired from third parties or in directed sales programs may be excluded from underwriting compensation. Such approach would start with the presumption that the issuer securities received during the review period would be underwriting compensation. FINRA, however, would consider the following factors, as well as any other relevant factors and circumstances when considering whether securities of the issuer acquired from third parties may be excluded from underwriting compensation. Specifically, these include: (1) the nature of the relationship between the issuer and the third party, if any; (2) the nature of the transactions in which the securities were acquired, including, but not limited to, whether the transactions are engaged in as part of the participating member's ordinary course of business; and (3) any disparity between the price paid and the offering price or market price.

With respect to issuer securities acquired in directed sales programs (commonly called friends and family programs), the proposed definition of "participating member" includes any FINRA member that is participating in a public offering, any affiliate or associated person of the member, and any immediate family of an associated person of the member, but does not include the issuer.<sup>29</sup> Under proposed Supplementary Material .04 to Rule 5110, FINRA would consider the following factors, as well as any other relevant factors and circumstances when considering

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<sup>28</sup> See proposed Supplementary Material .01 to Rule 5110. See also Notice, supra note 3, for a full description of the proposal.

<sup>29</sup> See proposed Rule 5110(j)(15).



whether an acquisition of securities by a participating member pursuant to an issuer's directed sales program may be excluded from underwriting compensation: (1) the existence of a pre-existing relationship between the issuer and the person acquiring the securities; (2) the nature of the relationship; and (3) whether the securities were acquired on the same terms and at the same price as other similarly-situated persons participating in the directed sales program.

#### Venture Capital Exceptions

FINRA states that the proposed rule change would modify, clarify and expand the venture capital exceptions.<sup>30</sup> Specifically, the proposed rule change would no longer treat as underwriting compensation securities acquisitions covered by two of the current exceptions: (1) securities acquisitions and conversions to prevent dilution; and (2) securities purchases based on a prior investment history. This treatment is conditioned on prior investments in the issuer occurring before the review period.<sup>31</sup> When subsequent securities acquisitions take place (e.g., as a result of a stock split, a right of preemption, a securities conversion or when additional securities are acquired to prevent dilution of a long-standing interest in the issuer), the acquisition of the additional securities would not be treated as underwriting compensation under the proposed Rule.<sup>32</sup>

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<sup>30</sup> Rule 5110(d)(5) currently provides exceptions designed to distinguish securities acquired in bona fide venture capital transactions from those acquired as underwriting compensation (for brevity, referred to herein as the "venture capital exceptions"). The proposed rule change would modify, clarify and expand the exceptions to further facilitate members' participation in bona fide venture capital transactions. FINRA states that the venture capital exceptions would include several restrictions to ensure the protection of other market participants and that the exceptions are not misused to circumvent the requirements of Rule 5110. See Notice, supra note 3.

<sup>31</sup> See proposed Supplementary Material .01(b)(14), (16-18).

<sup>32</sup> The proposed rule change would add these acquisitions to the list of examples of payments that are not underwriting compensation because they are based on a prior

FINRA also proposes to broaden two of the current venture capital exceptions regarding purchases and loans by certain affiliates, and investments in and loans to certain issuers, by removing a limitation on acquiring more than 25% of the issuer's total equity securities.<sup>33</sup> These venture capital exceptions specify that the affiliate must be primarily in the business of making investments or loans. FINRA states that the proposed rule change expands the scope of these exceptions to include that the affiliate, directly or through a subsidiary it controls, must be in such business and further permits that the entity may be newly formed by such affiliate.

With respect to the current venture capital exception relating to private placements with institutional investors, the proposal would require that the institutional investors participating in the offering are not affiliates of a FINRA member and must purchase at least 51% of the total number of securities sold in the private placement at the same time and on the same terms.<sup>34</sup> In addition, the proposed rule change would raise the percent that participating members in the aggregate may acquire from 20% to 40% of the securities sold in the private placement.<sup>35</sup> The proposed rule change would expand the scope of proposed FINRA Rule 5110(d)(3) to include providing services for a private placement (rather than just acting as a placement agent).<sup>36</sup>

FINRA proposes to adopt a new venture capital exception where a highly regulated entity with significant disclosure requirements and independent directors who monitor investments is also making a significant co-investment in an issuer and is receiving securities at the same price

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investment history and are subject to the terms of the original securities that were acquired before the review period. See proposed Supplementary Material .01(b)(14), (16-18).

<sup>33</sup> See proposed Rule 5110(d)(1) and (2).

<sup>34</sup> See Notice, supra note 3, 84 FR at 18597.

<sup>35</sup> See proposed Rule 5110(d)(3)(C).

<sup>36</sup> See proposed Rule 5110(d)(3).

and on the same terms as the participating member. The exception applies for securities acquired in a private placement before the required filing date of the public offering by a participating member 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.

The proposed rule change would also provide some additional flexibility in the availability of the venture capital exceptions for securities acquired where the public offering has been significantly delayed. The proposed rule change would take a principles-based approach in considering whether it is appropriate to treat as underwriting compensation securities acquired by a member after the required filing date in a transaction that, except for the timing, would otherwise meet the requirements of a venture capital exception.<sup>37</sup>

#### Treatment of Non-Convertible or Non-Exchangeable Debt Securities and Derivatives

The proposed rule change would expressly provide that non-convertible or non-exchangeable debt securities and derivative instruments<sup>38</sup> acquired in a transaction unrelated to a public offering would not be underwriting compensation.<sup>39</sup> In contrast, for any non-convertible or non-exchangeable debt securities and derivative instruments acquired in a transaction related to the public offering, the proposed rule change would clarify that: (1) a description of those securities and derivative instruments must be filed with FINRA; and (2) this description must be

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<sup>37</sup> See Notice, supra note 3, 84 FR at 18597.

<sup>38</sup> Consistent with the current Rule, the proposed rule change would define the term “derivative instrument” to mean any eligible OTC derivative instrument as defined in Rule 3b-13(a)(1), (2) and (3) of the Exchange Act. See proposed Supplementary Material .06(b) to Rule 5110.

<sup>39</sup> See proposed Supplementary Material .01(b)(19) to Rule 5110.

accompanied by a representation that a registered principal or senior manager of the participating member has determined if the transaction was or will be entered into at a fair price.<sup>40</sup>

FINRA also proposes to clarify that non-convertible or non-exchangeable debt securities and derivative instruments acquired in a transaction related to the public offering at a fair price would be considered underwriting compensation but would have no compensation value. In contrast, the proposed rule change would provide that non-convertible or non-exchangeable debt securities and derivative instruments acquired in a transaction related to the public offering but not at a fair price would be considered underwriting compensation and subject to the normal valuation requirements of Rule 5110.<sup>41</sup>

#### Lock-Up Restrictions

FINRA states that, subject to some exceptions, Rule 5110 requires in any public equity offering a 180-day lock-up restriction on securities that are considered underwriting compensation. The proposed rule change would provide that the lock-up period begins on the

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<sup>40</sup> See proposed Rule 5110(a)(4)(B)(iv)(a). Generally consistent with current Rule 5110, the proposed rule change would define the term “fair price” to mean the participating members have priced a derivative instrument or non-convertible or non-exchangeable debt security in good faith; on an arm’s length, commercially reasonable basis; and in accordance with pricing methods and models and procedures used in the ordinary course of their business for pricing similar transactions. The proposed rule change would also clarify that a derivative instrument or other security received as compensation for providing services for the issuer, for providing or arranging a loan, credit facility, merger, acquisition or any other service, including underwriting services will not be deemed to be entered into or acquired at a fair price. See proposed Supplementary Material .06(b) to Rule 5110.

<sup>41</sup> See, e.g., proposed Supplementary Material .06(a) to Rule 5110; proposed Rule 5110(c); Notice, supra note 3.

date of commencement of sales of the public equity offering (rather than the date of effectiveness of the prospectus).<sup>42</sup>

FINRA proposes to add an exception from the lock-up restriction for securities acquired from an issuer that meets the registration requirements of Registration Forms S-3, F-3 or F-10.<sup>43</sup> The proposed rule change would also add an exception from the lock-up restriction for securities that were acquired in a transaction meeting one of Rule 5110's venture capital exceptions.<sup>44</sup> The proposed rule change would also add an exception from the lock-up restriction for securities that were received as underwriting compensation and are registered and sold as part of a firm commitment offering.<sup>45</sup>

FINRA proposes to provide clarity about the treatment of non-convertible or non-exchangeable debt securities and derivative instruments acquired in transactions related to a public offering and whether those securities are subject to the lock-up requirement.<sup>46</sup>

The proposed rule change would provide that the lock-up restriction does not apply to derivative instruments acquired in connection with a hedging transaction related to the public

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<sup>42</sup> See proposed Rule 5110(e)(1)(A). The proposed rule change also would provide that the lock-up restriction must be disclosed in the section on distribution arrangements in the prospectus or similar document consistent with proposed Supplementary Material .05 requiring disclosure of the material terms of any securities. See proposed Rule 5110(e)(1)(B).

<sup>43</sup> See proposed Rule 5110(e)(2)(A)(iii).

<sup>44</sup> See, e.g., proposed Rule 5110(e)(2)(A)(vi); Notice, *supra* note 3.

<sup>45</sup> See, e.g., proposed Rule 5110(e)(2)(A)(viii); Notice, *supra* note 3.

<sup>46</sup> For a full description of this proposal, see Notice, *supra* note 3. See, also, proposed Rule 5110(e)(2)(A)(iv).

offering and at a fair price.<sup>47</sup> In addition, FINRA proposes to add an exception to the lock-up restriction to permit the transfer or sale of the security back to the issuer in a transaction exempt from registration with the SEC.<sup>48</sup> FINRA also proposes to modify the lock-up exception in current Rule 5110(g)(2)(A)(ii) to permit the transfer of any security to the member's registered persons or affiliates if all transferred securities remain subject to the restriction for the remainder of the lock-up period.<sup>49</sup>

Finally, because proposed Supplementary Material .01(b)(20) would provide that securities acquired subsequent to the issuer's IPO in a transaction exempt from registration under Rule 144A of Securities Act would not be underwriting compensation, FINRA states that the proposed rule change would correspondingly delete as unnecessary the current exception from the lock-up restriction for those securities.<sup>50</sup>

#### Prohibited Terms and Arrangements

FINRA proposes to clarify and amend the list of prohibited unreasonable terms and arrangements in connection with a public offering of securities.<sup>51</sup> For example, the proposed rule change would clarify that it would be considered a prohibited arrangement for any underwriting compensation to be paid prior to the commencement of sales of public offering, except: (1) an

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<sup>47</sup> See proposed Rule 5110(e)(2)(A)(v). Derivative instruments acquired in transactions related to the public offering that do not meet the requirements of the exception would continue to be subject to the lock-up restriction. See Notice, *supra* note 3.

<sup>48</sup> See proposed Rule 5110(e)(2)(B)(iii).

<sup>49</sup> See proposed Rule 5110(e)(2)(B)(i). The proposed rule change would retain the current exception to the lock up for the exercise or conversion of any security, if all such securities received remain subject to the lock-up restriction for the remainder of the 180-day lock-up period. See proposed Rule 5110(e)(2)(B)(ii).

<sup>50</sup> See current Rule 5110(g)(2)(A)(viii).

<sup>51</sup> See proposed Rule 5110(g).

advance against accountable expenses actually anticipated to be incurred, which must be reimbursed to the issuer to the extent not actually incurred; or (2) advisory or consulting fees for services provided in connection with the offering that subsequently is completed according to the terms of an agreement entered into by an issuer and a participating member.<sup>52</sup>

### Defined Terms

The proposal would consolidate the defined terms in one location at the end of the Rule, which FINRA believes will simplify and clarify FINRA Rule 5110's defined terms.<sup>53</sup> For example, FINRA proposes to consolidate the various provisions that address what constitutes underwriting compensation into a single, new definition of "underwriting compensation."<sup>54</sup> The proposed rule change also would eliminate the term "underwriter and related persons" and instead use the defined term "participating member."<sup>55</sup>

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<sup>52</sup> See proposed Rule 5110(g)(4). For a complete description of the proposal with respect to prohibited terms and arrangements, see Notice, supra note 3, 84 FR at 18599-600, and Exhibit 5 as originally filed.

<sup>53</sup> For a complete description of the proposal with respect to defined terms, see Notice, supra note 3, 84 FR at 18600, and Exhibit 5 as originally filed.

<sup>54</sup> See proposed Rule 5110(j)(22).

<sup>55</sup> FINRA states that, substantively consistent with the current Rule, the proposed rule change would define "participating member" to include any FINRA member that is participating in a public offering, any affiliate or associated person of the member, and any "immediate family," but does not include the issuer. See proposed Rule 5110(j)(15). While not included in the "participating member" definition, the broad definition of underwriting compensation would include underwriter's counsel fees and expenses, financial consulting and advisory fees and finder's fees. As such, FINRA believes that the definition of "underwriting compensation" would ensure that the Rule addresses fees and expenses paid to persons previously covered by the term "underwriter and related persons." In addition, the term "immediate family" is clarified for readability in proposed Rule 5110(j)(8) to mean the spouse or child of an associated person of a member and any relative who lives with, has a business relationship with, or provides to or receives support from an associated person of a member. See Notice, supra note 3, for a full description of the proposal as originally filed.

## Valuation of Securities

The proposal would retain the current method for valuing options, warrants and other convertible securities received as underwriting compensation in the current Rule.<sup>56</sup>

### B. Notice of Partial Amendment No. 1

#### 1. Introduction

Set forth in Section II.B.2 below is the summary of Partial Amendment No. 1 to the proposed rule change, as prepared and submitted by FINRA to the Commission.<sup>57</sup>

#### 2. Self-Regulatory Organization’s Statement of the Purpose of the Proposed Rule Change, as Modified by Partial Amendment No.1

Partial Amendment No. 1 makes the following changes to the Proposal: (1) modifies the requirement to file a description of any securities of the issuer acquired and beneficially owned by any participating member during the review period; (2) excepts “actively-traded” securities from the lock-up restriction; (3) excludes from underwriting compensation in a revised public offering accountable expenses received pursuant to Rule 5110(g)(5)(A) in a prior offering; (4) exempts issuer self-tender offers from the filing and substantive requirements of the Rule; (5) clarifies the proposed investment grade debt exemption in Rule 5110(h)(1)(A); (6) modifies some proposed defined terms; and (7) clarifies when securities acquired would be deemed underwriting compensation pursuant to Rule 5110.

#### Filing a Description of Acquired Securities

Commenters stated that proposed Rule 5110(a)(4)(B)(iv), which requires the filing of a “description of any securities of the issuer acquired and beneficially owned by any participating

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<sup>56</sup> See proposed Rule 5110(c).

<sup>57</sup> The text of the proposed rule change, including Partial Amendment No. 1, is available on FINRA’s website at <http://www.finra.org/industry/rule-filings/sr-finra-2019-012>.



member during the review period,” should be limited to a description of any securities-based underwriting compensation acquired during the review period by the participating member (i.e., no description for securities that do not constitute underwriting compensation).<sup>58</sup> Commenters stated that the provision would impose significant additional costs and administrative burdens on members and, due to likely fluctuations in holdings over the review period, would present compliance challenges.

A description of issuer securities acquired and beneficially owned by the participating member during the review period is needed to evaluate the underwriting terms and arrangements of the public offering and to ensure that there is no circumvention of the Rule. In response to the commenters’ concerns and to reduce costs and administrative burdens on participating members, FINRA is proposing in this Partial Amendment No. 1 to revise Rule 5110(a)(4)(B)(iv) to not require filing a description of any securities acquired in accordance with Supplementary Material .01(b), which sets forth a non-exhaustive list of payments that generally would not be deemed to be underwriting compensation. This approach would reduce filing burdens for members regarding payments and benefits that would not be considered underwriting compensation, while ensuring that FINRA receives adequate information about other issuer securities acquired and beneficially owned by the participating member during the review period to fully evaluate the underwriting terms and arrangements of the public offering and to ensure that there is no circumvention of the Rule.<sup>59</sup>

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<sup>58</sup> See ABA, Davis Polk and SIFMA.

<sup>59</sup> Specifically, Rule 5110(a)(4)(B)(iv) would be revised to: “(iv) a description of any securities of the issuer acquired and beneficially owned by any participating member during the review period, provided that: a. non-convertible or non-exchangeable debt securities and derivative instruments acquired in a transaction related to the public offering must be filed and also accompanied by a representation that a registered

### Lock-Up Restriction

SIFMA suggested eliminating the lock-up requirement for offerings of securities that are “actively-traded” (as defined in Rule 101(c)(1) of SEC Regulation M). The Proposal would add exceptions from the lock-up restriction where other protections or market forces obviate the need for the restriction. Due to the existing public market for the securities, the Proposal included a proposed exception from the lock-up restriction for securities acquired from an issuer that meets the registration requirements of SEC Registration Forms S-3, F-3 or F-10. The justification for this proposed exception also applies to securities that are “actively-traded” as defined in Rule 101(c)(1) of SEC Regulation M (i.e., securities that have an average daily trading volume value of at least \$1 million and are issued by an issuer whose common equity securities have a public float value of at least \$150 million; provided, however, that such securities are not issued by the distribution participant or an affiliate of the distribution participant). Accordingly, FINRA is proposing in this Partial Amendment No. 1 to add Rule 5110(e)(2)(A)(ix) to provide that the lock-up restriction would not apply “to a security that is ‘actively-traded’ (as defined in Rule 101(c)(1) of SEC Regulation M).”

### Revised Public Offerings

Commenters stated that consideration of prior compensation received in a revised public offering is not appropriate, particularly if the compensation is received for services actually rendered or for out-of-pocket expenses actually incurred in connection with the prior offering that was not completed in compliance with the requirements of proposed Rule 5110(g)(4) and

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principal or senior manager of the participating member has determined if the transaction was or will be entered into at a fair price; [and] b. non-convertible or non-exchangeable debt securities and derivative instruments need not be filed if acquired in a transaction that is unrelated to the public offering[.]; and c. securities if acquired in accordance with Supplementary Material .01(b) need not be filed.”

(g)(5).<sup>60</sup> Commenters stated that it is unclear: (1) what a “revised public offering” is; (2) whether the inclusion is limited solely to compensation received (or arrangements for compensation entered into) during the review period for the revised public offering; and (3) how proposed Supplementary Material .01(a)(13) relates to proposed Rule 5110(a)(4)(C) requiring notice to FINRA of compensation received for a prior offering that was not completed.

As SIFMA acknowledges, Rule 5110 currently applies to underwriting compensation received in a prior public offering that was not completed when the participating member participates in the revised public offering. When assessing whether an offering is a revised public offering, FINRA looks at the facts and circumstances of the current offering and any relevant prior offering that was not completed with a focus on the material offering terms and underwriting terms and arrangements. When assessing a revised public offering, FINRA would consider securities and other compensation received as part of the prior offering that was not completed and during the review period for the revised public offering. Considering compensation received in the prior offering that was not completed is vital to preventing a participating member from being compensated twice for performing the same services for the issuer. Furthermore, the compensation received in a prior terminated offering would be considered underwriting compensation under Rule 5110 only if the member participates in the revised public offering.

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<sup>60</sup> See ABA, Davis Polk and SIFMA. SIFMA acknowledges that proposed Supplementary Material .01(a)(13), which provides that “underwriting compensation” includes “any compensation paid to any participating member in connection with a prior proposed public offering that was not completed, if the member firm participates in the revised public offering,” is consistent with a similar provision in the current Rule. See Rule 5110(c)(3)(A)(xiii).

As the commenters noted, a participating member in a revised public offering may have received payment for accountable expenses in the prior offering that was not completed. FINRA believes that these expenses may be excluded from underwriting compensation in the revised public offering and, accordingly, FINRA is proposing in this Partial Amendment No. 1 to revise Supplementary Material .01(a)(13) to exclude from underwriting compensation accountable expenses received pursuant to Rule 5110(g)(5)(A).<sup>61</sup>

#### Issuer Self-Tender Offers

With respect to the exemption in Rule 5110(h)(2)(G) for third-party tender offers, ABA suggested revising this exemption to also include tender offers by issuers for their own securities under the Exchange Act. ABA stated that there is little logic for excluding third-party tender offers, but not issuer self-tenders, when a FINRA member may act as dealer manager in connection with either type of transaction. FINRA is proposing in this Partial Amendment No. 1 to amend Rule 5110(h)(2)(G) to apply to “tender offers made pursuant to SEC Regulation 14D or Rule 13a-4 under the Exchange Act.” Both third-party tender offers and issuer self-tender offers are subject to disclosure, filing and procedural requirements as set forth in the Exchange Act. Moreover, issuer self-tender offers have historically not been filed with FINRA for review pursuant to Rule 5110.

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<sup>61</sup> Specifically, Supplementary Material .01(a)(13) would be revised to provide that underwriting compensation would include “any compensation paid to any participating member in connection with a prior proposed public offering that was not completed, if the member firm participates in the revised public offering, except that accountable expenses received pursuant to paragraph (g)(5)(A) shall not be deemed underwriting compensation.”

### Investment Grade Debt Exemption

With respect to the proposed investment grade debt exemption in Rule 5110(h)(1)(A), Rothwell opposed including public offerings where the issuer has securities in the same series that have equal rights and obligations as investment grade rated securities because doing so may allow an issuer to avoid filing a public offering of any type of securities with FINRA for review based on the issuer having only outstanding unrated non-convertible debt or preferred securities that the issuer deems to be in the same series as qualifying reacquired Treasury securities that were once rated investment grade. Rothwell suggested adding “outstanding” after “has” to ensure that an offering of debt or equity securities can rely only on the exemption at a time when the issuer has outstanding a qualifying issue of investment grade rated debt or preferred securities so that Treasury securities cannot qualify for this purpose.

FINRA does not intend the exemption to apply where the issuer has only outstanding unrated non-convertible debt or preferred securities that the issuer deems to be in the same series as qualifying reacquired Treasury securities that were once rated investment grade. FINRA is proposing in this Partial Amendment No. 1 to revise proposed Rule 5110(h)(1)(A) to exempt “securities offered by a bank, corporate issuer, foreign government or foreign government agency that has outstanding unsecured non-convertible debt with a term of issue of at least four years or unsecured non-convertible preferred securities that are investment grade rated, as defined in Rule 5121(f)(8), or are outstanding securities in the same series that have equal rights and obligations as investment grade rated securities, provided that an initial public offering of equity is required to be filed.”

## Defined Terms

ABA suggested that the definition of “bank” expressly include U.S. branches and agencies of a foreign bank, which have been interpreted by the SEC to constitute U.S. banks for other purposes under the federal securities laws, including in connection with Rule 15a-6 under the Exchange Act. ABA stated that the need for a “foreign bank” to apply to FINRA for an exemption under the Rule is unnecessarily burdensome, particularly in the context of reliance on the investment grade debt exemption set forth in Proposed Rule 5110(h)(1)(A).

FINRA is proposing in this Partial Amendment No. 1 to amend the proposed defined term bank in Rule 5110(j)(2) to mean “a bank as defined in Section 3(a)(6) of the Exchange Act, a branch or agency in the United States of a foreign bank that is supervised and examined by a federal or state banking authority and otherwise meets the requirements of Section 3(a)(6) of the Exchange Act, or [is] a foreign bank that has been granted an exemption under this Rule and shall refer only to the regulated entity, not its subsidiaries or other affiliates.” As the ABA noted, this approach is consistent with the SEC’s interpretation of what is a bank for other purposes under the federal securities laws. For example, the SEC provided that for purposes of Rule 15a-6 under the Exchange Act, a foreign bank is excluded from the defined term “bank” except to the extent that the “foreign bank establishes a branch or agency in the United States that is supervised and examined by a federal or state banking authority and otherwise meets the requirements of section 3(a)(6).”<sup>62</sup>

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<sup>62</sup> See Securities Exchange Act Release No. 27017 (July 11, 1989), 54 FR 30013 (July 18, 1989) (File No. S7-11-88, Registration Requirements for Foreign Broker-Dealers, note 16) and Frequently Asked Questions Regarding Rule 15a-6 and Foreign Broker-Dealers, footnote 3, (March 21, 2013) available at <https://www.sec.gov/divisions/marketreg/faq-15a-6-foreign-bd.htm>.

SIFMA supported carving out “participating members” from the defined term “issuer” and suggested a clarifying carve out to exclude any participating member that is the actual corporate issuer of the securities being offered or a selling security holder offering its own beneficially held securities to the public. FINRA is proposing in this Partial Amendment No. 1 to amend the defined term “issuer” to exclude a participating member, except where the participating member is offering its securities. Specifically, FINRA proposes to revise proposed Rule 5110(j)(12) to define “issuer” to mean “a registrant or other person that is offering its securities to the public, any selling security holder offering securities to the public, any affiliate of the registrant or such other person or selling security holder, and the officers or general partners, and directors thereof, but does not include a participating member unless the participating member is itself the registrant or a selling security holder offering its own beneficially held securities to the public.”

The ABA suggested a technical change to the defined term “public offering” in proposed Rule 5110(j)(18)(A) to update the reference to offerings pursuant to Section 4(a)(6) of the Securities Act to Section 4(a)(5) of the Securities Act. FINRA is proposing in this Partial Amendment No. 1 to amend the defined term’s reference to these offerings as suggested by the commenter.

#### Underwriting Compensation

Commenters asserted that participating members’ purchases of securities in the public offering at the public offering should not be underwriting compensation subject to Rule 5110.<sup>63</sup>

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<sup>63</sup> See ABA, Davis Polk, Rothwell and SIFMA. Commenters noted questions raised by the inclusion as underwriting compensation of any equity securities acquired by a participating member during the review period under Supplementary Material .01(a)(7) and scope of the defined term “review period” in proposed Rule 5110(j)(20).

FINRA would interpret the Proposal not to include as underwriting compensation non-convertible securities purchased by the participating member in a public offering at the public offering price during the review period. FINRA is proposing in this Partial Amendment No. 1 to revise the Supplementary Material to expressly exclude securities purchased on these terms from being deemed underwriting compensation under the Proposal.<sup>64</sup> FINRA has seen acquisitions of convertible securities by a participating member with negotiated or preferential terms prohibited under proposed Rule 5110(g)(8). FINRA would consider these securities to be underwriting compensation.

As set forth in the Proposal, proposed Supplementary Material .01(b)(12) would provide that compensation received through any stock bonus, pension, or profit-sharing plan that qualifies under Section 401 of the Internal Revenue Code or a similar plan is not underwriting compensation. ABA recommended revising the provision to expressly include securities received under a written compensatory benefit plan in an offering exempt from registration pursuant to Rule 701 under the Securities Act and any other “employee benefit plan” (as such term is defined in Securities Act Rule 405). Davis Polk requested confirmation that grants of equity compensation to immediate family of participating members, other than new employees

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<sup>64</sup> Specifically, FINRA is proposing in this Partial Amendment No. 1 to amend proposed Supplementary Material .01(a)(7) to provide that underwriting compensation includes “common or preferred stock, options, warrants, and other equity securities, including debt securities convertible to or exchangeable for equity securities, beneficially owned, as defined in Rule 5121 by the participating members the value of which is determined pursuant to this Rule, and acquired during the review period, as defined in this Rule, except that non-convertible securities purchased by a participating member in a public offering at the public offering price during the review period shall not be deemed underwriting compensation;”.



of the issuer, in the ordinary course of business pursuant to bona fide equity compensation arrangements will not be deemed underwriting compensation.<sup>65</sup>

To provide additional clarity, FINRA is proposing in this Partial Amendment No. 1 to revise Supplementary Material .01(b)(12) to refer to a written compensatory benefit plan in an offering exempt from registration pursuant to Rule 701 under the Securities Act and any other employee benefit plan (as defined in Securities Act Rule 405). As revised, Supplementary Material .01(b)(12) would exclude from underwriting compensation “compensation received through any stock bonus, pension, employee benefit plan, or profit-sharing plan that qualifies under Section 401 of the Internal Revenue Code or a similar plan, including, but not limited to, an employee benefit plan as defined in Securities Act Rule 405 or a compensatory benefit plan or compensatory benefit contract exempt from registration pursuant to Securities Act Rule 701...”

### III. Summary of Comments and FINRA’s Response<sup>66</sup>

The Commission received six comment letters on the filing as originally proposed.<sup>67</sup> Subsequently, FINRA submitted Partial Amendment No. 1 and a response to the comments.<sup>68</sup> The comments and FINRA’s response are summarized below.

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<sup>65</sup> Davis Polk also disagreed with the ABA that the exclusion from underwriting compensation only apply to equity grants made pursuant to Rule 701 under the Securities Act due to limitations on annual grants of equity compensation under Rule 701 that force reliance on Section 4(a)(2) of the Securities Act. However, it is not clear that the ABA intended to propose the exclusion as suggested by Davis Polk.

<sup>66</sup> See Notice, supra note 3, for full FINRA discussion of the original filing.

<sup>67</sup> See supra note 5 and accompanying text.

<sup>68</sup> See FINRA Response, supra note 6.

### Overall Proposal

Four commenters support FINRA's efforts to review, streamline and modernize the Rule for the benefit of market participants but offer suggested modifications to some aspects of the proposal.<sup>69</sup> As discussed below, one commenter expresses support and suggests a modification of a proposed exemption, but otherwise does not comment on other aspects of the proposal.<sup>70</sup> In response, FINRA proposes certain modifications to the initial proposal as described in detail below.

One commenter believes that excessive underwriting compensation should be addressed through disclosure to investors and states that FINRA Rule 5110 is inconsistent with the Exchange Act and the Securities Act.<sup>71</sup> In response, FINRA states its belief that, while disclosure of underwriting compensation is an important component of Rule 5110, disclosure alone is not sufficient to prohibit unfair underwriting terms and arrangements that disadvantage issuers and investors in public offerings of securities.

### Filing Requirements

Three commenters state that several of the proposed filing requirements are unnecessary.<sup>72</sup> Namely, commenters argue that the following filing requirements should be eliminated: (1) disclosure of holdings that are excluded from underwriting compensation; (2) M&A and private placement engagement letters; (3) a representation as to whether any officer or director of the issuer and any beneficial owner of 5% or more of any class of the issuer's equity

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<sup>69</sup> See ABA, Davis Polk, Rothwell and SIFMA, supra note 5.

<sup>70</sup> See CAI, supra note 5.

<sup>71</sup> See Kaswell, supra note 5.

<sup>72</sup> See ABA, Davis Polk and SIFMA, supra note 5.

and equity-linked securities is an associated person or affiliate of a participating member; (4) notification of underwriting compensation received in terminated or revised offerings; and (5) a description of securities acquired in bona fide venture capital transactions.<sup>73</sup>

In response to commenters' concerns, FINRA proposes in Partial Amendment No. 1 to revise FINRA Rule 5110(a)(4)(B)(iv) to not require filing a description of any securities acquired in accordance with Supplementary Material .01(b), which sets forth a non-exhaustive list of payments that generally would not be deemed to be underwriting compensation.<sup>74</sup> With respect to a revised public offering, as discussed in Partial Amendment No. 1, and in response to commenters' concerns, FINRA proposes to revise Supplementary Material .01(a)(13) to exclude from underwriting compensation accountable expenses received pursuant to Rule 5110(g)(5)(A).<sup>75</sup>

FINRA, however, continues to believe that M&A and private placement engagement letters should be required to be filed with FINRA so that it may determine if they impact the underwriting terms and arrangements for the public offering.<sup>76</sup> Likewise, FINRA continues to believe that beneficial owners of 5% or more must be disclosed.<sup>77</sup> FINRA also continues to

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<sup>73</sup> See id.

<sup>74</sup> See FINRA Response, supra note 6 at 3-4.

<sup>75</sup> Specifically, Supplementary Material .01(a)(13) would be revised to provide that underwriting compensation would include “any compensation paid to any participating member in connection with a prior proposed public offering that was not completed, if the member firm participates in the revised public offering, except that accountable expenses received pursuant to paragraph (g)(5)(A) shall not be deemed underwriting compensation.” See also FINRA Response, supra note 6 at 6 n.10.

<sup>76</sup> See FINRA Response, supra note 6 at 3.

<sup>77</sup> See FINRA Response, supra note 6 at 4-5. See also ABA, Davis Polk and SIFMA, supra note 5. ABA and SIFMA suggest a 25% threshold, while Davis Polk suggests a 10% threshold.

believe that underwriting compensation received or to be received in terminated offerings is relevant to FINRA’s evaluation of compliance with Rule 5110.<sup>78</sup>

FINRA proposes to retain the requirement that a description be filed for any securities acquired in a bona fide venture capital transaction as set forth in proposed Rule 5110(d). FINRA believes that a description of the securities is needed for FINRA to assess whether the acquisition meets the requirements for a venture capital exception or whether the securities should instead be treated as underwriting compensation.<sup>79</sup>

Although most commenters suggest scaling back the filing requirements, one commenter suggests that FINRA withdraw the proposed expansion of an exemption from such requirement. Specifically, the commenter proposes that the expansion of “seasoned issuer” filing exemption to an issuer’s public offerings where the issuer has “securities in the same series that have equal rights and obligations as investment grade rated securities” be removed.<sup>80</sup> Moreover, this and another commenter requested additional clarification on the “seasoned issuer” exemption.<sup>81</sup> Namely, one commenter sought clarification regarding whether the issuer’s qualifying debt or preferred securities for purposes of the exemption must be issued and outstanding.<sup>82</sup> The other commenter requested clarification that the use of the term “corporate issuer” in the exemption is not meant to exclude issuers if they are not organized in “corporate” form.<sup>83</sup> In response to commenters’ concerns, FINRA proposes to further revise Rule 5110(h)(1)(A) to exempt

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<sup>78</sup> See FINRA Response, supra note 6 at 5.

<sup>79</sup> See FINRA Response, supra note 6 at 4.

<sup>80</sup> See Rothwell, supra note 5.

<sup>81</sup> See Rothwell and ABA, supra note 5.

<sup>82</sup> See Rothwell, supra note 5.

<sup>83</sup> See ABA, supra note 5.

“securities offered by a bank, corporate issuer, foreign government or foreign government agency that has outstanding unsecured non-convertible debt with a term of issue of at least four years or unsecured non-convertible preferred securities that are investment grade rated, as defined in Rule 5121(f)(8), or are outstanding securities in the same series that have equal rights and obligations as investment grade rated securities, provided that an initial public offering of equity is required to be filed” (emphasis added). FINRA further clarifies that it does not intend the exemption to apply where the issuer has only outstanding, unrated non-convertible debt or preferred securities that the issuer deems to be in the same series as qualifying reacquired Treasury securities that were once rated investment grade. In addition, FINRA states that it would interpret “corporate issuers” to include, among other entities, limited partnerships and limited liability companies.<sup>84</sup>

#### Disclosure

One commenter suggests adopting a de minimis exception for itemized disclosure under which participating members may disclose a maximum aggregate value for items of underwriting compensation.<sup>85</sup> In response, FINRA notes that it previously considered the Rule’s disclosure requirements in responding to comments received to the Notice 17-15 Proposal, and has decided to retain the current disclosure requirements.<sup>86</sup>

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<sup>84</sup> See FINRA Response, supra note 6 at 14.

<sup>85</sup> See SIFMA, supra note 5.

<sup>86</sup> See FINRA Response, supra note 6 at 7.

## Valuation

Two commenters request clarification, as well as offer suggestions, on FINRA's proposal to modify Rule 5110's calculations for valuing convertible and non-convertible securities.<sup>87</sup> Commenters request alternative valuation methodologies on a case-by-case basis<sup>88</sup> and for unit securities.<sup>89</sup> One commenter also requests, for purposes of clarification, express exclusion from valuation as underwriting compensation for options and other derivatives acquired at a fair price.<sup>90</sup>

FINRA proposes to retain the methods in the current Rule for valuing options, warrants and other convertible securities received as underwriting compensation. FINRA states that exemptive relief may be available on a case-by-case basis pursuant to Rule 5110(i) for a member firm that seeks to use a single, consistently applied alternative valuation methodology.<sup>91</sup> FINRA also notes that it has previously provided guidance for valuing unit securities.<sup>92</sup> With respect to options and other derivatives acquired at a fair price, FINRA notes that the requested clarification is set forth in proposed Rule 5110(c)(5), which states "[a]ny non-convertible or non-exchangeable debt or derivative instrument acquired or entered into at a 'fair price' as defined in Supplementary Material .06(b) and underwriting compensation received in or receivable in the settlement, exercise or other terms of such non-convertible or non-exchangeable debt or

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<sup>87</sup> See SIFMA and Rothwell, supra note 5.

<sup>88</sup> See SIFMA, supra note 5 at 8.

<sup>89</sup> See Rothwell, supra note 5 at 12.

<sup>90</sup> See SIFMA, supra note 5 at 8.

<sup>91</sup> See FINRA Response, supra note 6 at 8.

<sup>92</sup> See id.

derivative instrument shall not have a compensation value for purposes of determining underwriting compensation.”<sup>93</sup>

#### Venture Capital Exceptions

Commenters generally support the venture capital exceptions<sup>94</sup> with one commenter requesting clarification on the definition of “institutional investor” and suggesting that the exception be expanded to include other highly regulated entities.<sup>95</sup> The commenter also suggests that the venture capital exceptions should be clarified to provide that a participating member could make the determination as to the availability of an exception at the time of the acquisition of the securities.<sup>96</sup> In response, FINRA notes that it had previously considered these issues in responding to comments received to the Notice 17-15 Proposal<sup>97</sup> and declines to make further changes. FINRA states that it will retain the definition of “institutional investor” as proposed and also notes that whether an acquisition of the securities meets an exception must be determined before the required filing date.<sup>98</sup>

#### Lock-Up Restriction

One commenter suggests several changes to FINRA’s proposed lock-up restriction, such as eliminating the restriction for offerings of securities that are “actively-traded,” making consistent the lock-up period for participating members in a follow-on offering as the lock-up period for insiders, and allowing the sale or other disposition of locked-up securities by

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<sup>93</sup> See FINRA, supra note 6 at 8.

<sup>94</sup> See Rothwell and SIFMA, supra note 5.

<sup>95</sup> See SIFMA, supra note 5 at 4-5.

<sup>96</sup> See id.

<sup>97</sup> See FINRA Response, supra note 6 at 10.

<sup>98</sup> See id.

registered investment advisers who are participating members.<sup>99</sup> In response, as discussed in Partial Amendment No. 1, FINRA proposes to add Rule 5110(e)(2)(A)(ix) to provide that the lock-up restriction will not apply “to a security that is “actively-traded” (as defined in Rule 101(c)(1) of SEC Regulation M).”<sup>100</sup> FINRA also notes that it would consider any additional request for exemptive relief under Rule 5110 pursuant to Rule 5110(i).<sup>101</sup>

#### Non-Cash Compensation

Two commenters request clarification that restrictions on non-cash compensation as set forth in the current Rule and proposed Rule 5110(f) are not intended to limit or otherwise be inconsistent with other provisions in the Rule that implicitly permit the receipt by participating members of non-cash compensation under appropriate circumstances.<sup>102</sup> In response to the commenters’ request for clarification, FINRA confirms the commenters’ understanding regarding the restrictions on receipt of non-cash compensation.<sup>103</sup>

#### Prohibited Terms and Arrangements

One commenter, although generally supportive of the proposed changes relating to prohibited terms and arrangements in connection with a public offering of securities, offers two suggestions.<sup>104</sup> The commenter suggests that payments allowed prior to the commencement of sales of a public offering also be permitted in respect of offerings that are not completed if the payments are for services actually provided and the issuer has not terminated the services of the

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<sup>99</sup> See SIFMA, supra note 5 at 6.

<sup>100</sup> See FINRA Response, supra note 6 at 11.

<sup>101</sup> See id.

<sup>102</sup> See ABA, supra note 5 at 7; SIFMA, supra note 5 at 9.

<sup>103</sup> See FINRA Response, supra note 6 at 12.

<sup>104</sup> See ABA, supra note 5.



participating member for cause.<sup>105</sup> The commenter further suggests that Rule 5110(g)(11), which provides that a FINRA member may not “participate with an issuer in the public offering of securities if the issuer hires persons primarily for the purpose of solicitation, marketing, distribution or sales of the offering, except in compliance with Section 15(a) of the Exchange Act or [Exchange Act] Rule 3a4-1 and applicable state law,” should be further modified to limit this prohibition to those instances in which the FINRA member knows, or reasonably should have known, that the issuer had hired persons absent compliance with applicable federal or state securities laws.<sup>106</sup> FINRA believes that these specific modifications to proposed FINRA Rule 5110(g) are not necessary.<sup>107</sup>

#### Exemptions from Filing and Substantive Requirements

Commenters are generally supportive of FINRA’s proposal to exempt certain offerings from the filing requirements.<sup>108</sup> One commenter, however, requests that FINRA expand the exemptions to include tender offers by issuers for their own securities under the Exchange Act.

<sup>109</sup> In response to comment, as discussed in Partial Amendment No. 1, FINRA proposes to amend Rule 5110(h)(2)(G) to include tender offers by issuers for their own securities.<sup>110</sup>

Accordingly, Proposed Rule 5110(h)(2)(G) will apply to “tender offers made pursuant to SEC Regulation 14D or Rule 13a-4 under the Exchange Act.”<sup>111</sup>

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<sup>105</sup> See ABA, supra note 5 at 7-8.

<sup>106</sup> See id.

<sup>107</sup> See FINRA Response, supra note 6 at 12-13.

<sup>108</sup> See Rothwell, CAI and ABA, supra note 5.

<sup>109</sup> See ABA, supra note 5 at 10.

<sup>110</sup> See FINRA Response, supra note 6 at 14.

<sup>111</sup> See FINRA Response, supra note 6 at 14.

## Defined Terms

One commenter suggests that the definition of “bank” under proposed Rule 5110(j)(2) should also include the US branches and agencies of a foreign bank.<sup>112</sup> In response, as discussed in the Partial Amendment No. 1, FINRA proposes to amend the proposed definition of bank in Rule 5110(j)(2) to mean “a bank as defined in Section 3(a)(6) of the Exchange Act, a branch or agency in the United States of a foreign bank that is supervised and examined by a federal or state banking authority and otherwise meets the requirements of Section 3(a)(6) of the Exchange Act, or [is] a foreign bank that has been granted an exemption under this Rule and shall refer only to the regulated entity, not its subsidiaries or other affiliates.”<sup>113</sup>

Three commenters express concern over the term “experienced issuer” in Rule 5110(j)(6) and suggested alternatives or requested clarification.<sup>114</sup> For example, commenters express concern that the proposal would eliminate SEC and FINRA’s past interpretive guidance relating to the term.<sup>115</sup> FINRA, however, believes that the proposed definition of “experienced issuer” codifies standards currently in place and simplifies the analysis for the benefit of members.<sup>116</sup> FINRA also believes that any guidance and interpretation issued by the SEC or FINRA relating to the term remain valid and illustrative.<sup>117</sup>

One commenter requests to expand the defined term “independent financial adviser” in Rule 5110(j)(9) and revise proposed Rule 5110(j)(16) to allow an independent financial adviser

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<sup>112</sup> See ABA, supra note 5 at 10.

<sup>113</sup> See FINRA Response, supra note 6 at 15.

<sup>114</sup> See ABA, Davis Polk and SIFMA, supra note 5.

<sup>115</sup> See id.

<sup>116</sup> See FINRA Response, supra note 6 at 16.

<sup>117</sup> See id.

to provide ordinary services to an issuer and assist the issuer in preparing the offering document and other documents.<sup>118</sup> In response, FINRA disagrees with the suggested expansion of services that may be provided by the independent financial adviser.<sup>119</sup>

Three commenters suggest a variety of changes to the proposed definitions of “participate,” “issuer,” and “participating member.”<sup>120</sup> FINRA, however, does not agree with the commenters’ suggestions to create additional carve-outs from the definitions.<sup>121</sup> Nevertheless, in response to one commenter’s concern,<sup>122</sup> as discussed in the Partial Amendment No. 1, FINRA proposes to amend the defined term “issuer” to exclude a participating member, except where the participating member is offering its securities.<sup>123</sup>

One commenter suggest that the defined term “public offering” should expressly exclude securities offered or sold by a broker-dealer pursuant to Sections 4(a)(3) and 4(a)(4) of the Securities Act.<sup>124</sup> FINRA, in response, declines to make the suggested revision.<sup>125</sup>

Four commenters assert that participating members’ purchases of securities in a public offering at the public offering price should not be considered underwriting compensation subject

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<sup>118</sup> See Rothwell, supra note 5 at 14-15.

<sup>119</sup> See FINRA Response, supra note 6 at 17.

<sup>120</sup> See Rothwell, ABA, SIFMA and Davis Polk, supra note 5.

<sup>121</sup> See FINRA Response, supra note 6 at 18.

<sup>122</sup> See Rothwell, supra note 5.

<sup>123</sup> See FINRA Response, supra note 6 at 18.

<sup>124</sup> See ABA, supra note 5 at 11. The ABA also suggests a technical change to update the reference in proposed Rule 5110(j)(18)(A) to offerings pursuant to Section 4(a)(6) of the Securities Act to Section 4(a)(5) of the Securities Act. As discussed in the Partial Amendment No. 1, FINRA proposes to revise the public offering definition’s reference to these offerings as suggested by the commenter. See id.

<sup>125</sup> See FINRA Response, supra note 6 at 18.

to Rule 5110.<sup>126</sup> Moreover, two commenters suggest that proposed Supplementary Material .04, which addresses securities acquired by a participating member’s associated persons or their immediate family members in issuer directed sales programs, should be modified to focus only on securities acquired at a price lower than the public offering price.<sup>127</sup> In response, FINRA provides that it would interpret the proposal not to include as underwriting compensation non-convertible securities purchased by a participating member in a public offering at the public offering price during the review period. As discussed in the Partial Amendment No. 1, FINRA proposes to revise the Supplementary Material to expressly exclude securities purchased on these terms from being deemed underwriting compensation.<sup>128</sup>

Two commenters request clarification as to whether certain compensated parties would be considered “participating members” and thus their compensation be deemed underwriting compensation.<sup>129</sup> For example, one commenter requests confirmation that compensation received by a non-U.S. underwriter that is not itself a FINRA member or an affiliate of a participating FINRA member is not considered underwriting compensation.<sup>130</sup> FINRA confirms that such compensation is not underwriting compensation for the purposes of Rule 5110.<sup>131</sup>

Another commenter requests confirmation that fees and other compensation paid by an issuer to a foreign broker-dealer affiliated with a participating member in connection with the foreign distribution of an offering occurring both in the U.S. and outside the U.S. simultaneously

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<sup>126</sup> See ABA, Davis Polk, Rothwell and SIFMA, supra note 5.

<sup>127</sup> See ABA and SIFMA, supra note 5.

<sup>128</sup> See FINRA Response, supra note 6 at 19 n.27.

<sup>129</sup> See SIFMA and Davis Polk, supra note 5.

<sup>130</sup> See SIFMA, supra note 5 at 7-8.

<sup>131</sup> See FINRA Response, supra note 6 at 19-20.

should not be deemed underwriting compensation under Rule 5110.<sup>132</sup> In response, FINRA states that, if the participating members are able to divide underwriting compensation so as to separately allocate the underwriting compensation received by the non-U.S. broker-dealer for the non-U.S. portion of the global offering, FINRA would consider that separately allocated underwriting compensation to be outside the scope of Rule 5110 and not subject to the requirements of Rule 5110.<sup>133</sup>

Finally, another commenter notes that the inclusion of “finder’s fees, underwriter’s counsel fees, and securities” in the proposed “underwriting compensation” definition in Rule 5110(j)(22) is confusing and unnecessary in light of the much clearer and more fulsome language contained in the Supplementary Material .01.<sup>134</sup> In response, FINRA provides that it does not believe that the non-exhaustive examples in Supplementary Material .01 do not obviate the need for the defined term to capture the full scope of possible underwriting compensation.<sup>135</sup>

#### Underwriting Compensation

One commenter supports the changes in proposed Supplementary Material .01 of items that would or would not be underwriting compensation,<sup>136</sup> while others requested that additional items be excluded from underwriting compensation.<sup>137</sup> Specifically, commenters suggest the following be excluded: (1) the 1% valuation assigned to ROFRs;<sup>138</sup> (2) nominal gifts and

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<sup>132</sup> See Davis Polk, supra note 5 at 4.

<sup>133</sup> See FINRA Response, supra note 6 at 20.

<sup>134</sup> See ABA, supra note 5 at 4-5.

<sup>135</sup> See FINRA Response, supra note 6 at 20.

<sup>136</sup> See Rothwell, supra note 5 at 2.

<sup>137</sup> See ABA, Davis Polk and SIFMA, supra note 5.

<sup>138</sup> See SIFMA and ABA, supra note 5.

occasional entertainment;<sup>139</sup> (3) fees for services performed by participating members in the ordinary course of business unrelated to the distribution of the offering;<sup>140</sup> (4) bona fide market making activity;<sup>141</sup> and (5) any cash compensation, securities or other benefit received by an associated person, immediate family or affiliate of a participating member if the FINRA member or its parent or other affiliate is issuing its own securities in the public offering.<sup>142</sup> In response, FINRA disagrees with these suggestions and believes that such compensations should be reported to FINRA as underwriting compensation.<sup>143</sup>

Two commenters suggests revising Supplementary Material .01(b)(14) to exclude securities acquired as the result of an “exercise” of securities that were originally acquired prior to the review period.<sup>144</sup> In response, FINRA states that, pursuant to proposed Supplementary Material .01(b)(15), securities acquired as the result of an exercise of options or warrants that were originally acquired prior to the review period would not be underwriting compensation.<sup>145</sup>

Two commenters suggest that the exception in proposed Supplementary Material .01(b)(12) be expanded to include additional employee benefit plans.<sup>146</sup> In response to commenters’ suggestions,<sup>147</sup> and as discussed in the Partial Amendment No. 1, FINRA proposes to revise Supplementary Material .01(b)(12) to refer to a written compensatory benefit plan in an

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<sup>139</sup> See ABA, supra note 5.

<sup>140</sup> See Davis Polk, supra note 5.

<sup>141</sup> See ABA and Davis Polk, supra note 5.

<sup>142</sup> See SIFMA, supra note 5.

<sup>143</sup> See FINRA Response, supra note 6 at 20-23.

<sup>144</sup> See ABA and Davis Polk, supra note 5.

<sup>145</sup> See FINRA response, supra note 6 at 21-22.

<sup>146</sup> See ABA and Davis Polk, supra note 5

<sup>147</sup> See id.

offering exempt from registration pursuant to Rule 701 under the Securities Act and any other employee benefit plan (as defined in Securities Act Rule 405).<sup>148</sup>

FINRA Rule 5121 (Public Offerings of Securities With Conflicts of Interest)

Two commenters request clarification regarding the required participation by a QIU.<sup>149</sup> In response, FINRA states that it has previously provided guidance regarding QIU participation pursuant to Rule 5121, and is willing to consider requests for additional guidance on Rule 5121 separate from the proposal.<sup>150</sup>

IV. Proceedings to Determine Whether to Approve or Disapprove SR-FINRA-2019-012 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Exchange Act to determine whether the proposed rule change should be approved or disapproved.<sup>151</sup> Institution of proceedings appears appropriate at this time in view of the legal and policy issues raised by the proposal. As noted above, institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, the Commission seeks and encourages interested persons to comment on the issues presented by the proposed rule change and provide the Commission with arguments to

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<sup>148</sup> See FINRA Response, supra note 6 at 22.

<sup>149</sup> See, e.g., SIFMA, supra note 5 at 10, and ABA, supra note 5 at 8-9.

<sup>150</sup> See FINRA Response, supra note 6 at 23-24.

<sup>151</sup> 15 U.S.C. 78s(b)(2). Exchange Act Section 19(b)(2)(B) provides that proceedings to determine whether to disapprove a proposed rule change must be concluded within 180 days of the date of publication of notice of the filing of the proposed rule change. The time for conclusion of the proceedings may be extended for up to an additional 60 days if the Commission finds good cause for such extension and publishes its reasons for so finding or if the self-regulatory organization consents to the extension.

support the Commission's analysis as to whether to approve or disapprove the proposed rule change, as modified by Partial Amendment No. 1.

Pursuant to Section 19(b)(2)(B) of the Exchange,<sup>152</sup> the Commission is providing notice of the grounds for disapproval under consideration. The Commission is instituting proceedings to allow for additional analysis of the proposal's consistency with Section 15A(b)(9) of the Act,<sup>153</sup> which requires that FINRA's rules be designed to, among other things, promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. As summarized above, commenters raised, and sought clarification regarding, a number of issues. In response, FINRA recently submitted Partial Amendment No. 1 and response to comments. Accordingly, the Commission believes it is appropriate to institute proceedings to allow additional consideration and comments by both commenters and the Commission, and any potential response to comments or supplemental information by FINRA.

V. Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the issues raised by the proposed rule change, as modified by Partial Amendment No. 1. In particular, the Commission invites the written views of interested persons on whether the proposed rule change, as modified by Partial Amendment No. 1, is inconsistent with Section 15A(b)(6), or any other provision, of the Exchange Act, or the rules and regulations thereunder.

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<sup>152</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>153</sup> 15 U.S.C. 78o-3(b)(6).



Although there do not appear to be any issues relevant to approval or disapproval that would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.<sup>154</sup>

Interested persons are invited to submit written data, views, and arguments by [insert date 21 days from publication in the Federal Register] concerning whether the proposed rule change should be approved or disapproved. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert date 45 days from publication in the Federal Register]. In light of the concerns raised by the proposed rule change, as modified by Partial Amendment No. 1, as discussed above, the Commission invites additional comment on the proposed rule change, as modified by Partial Amendment No. 1, as the Commission continues its analysis of whether the proposed rule change, as modified by Partial Amendment No. 1, is consistent with Section 15A(b)(6), or any other provision of the Exchange Act, or the rules and regulations thereunder.

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2019-012 on the subject line.

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<sup>154</sup> Exchange Act Section 19(b)(2), as amended by the Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97 (1975), grants the Commission flexibility to determine what type of proceedings – either oral or notice and opportunity for written comments – is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Acts Amendments of 1975, Report of the Senate Committee on Banking, Housing and Urban Affairs to Accompany S. 249, S. Rep. No. 75, 94<sup>th</sup> Cong., 1<sup>st</sup> Sess. 30 (1975).

Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2019-012. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change. The Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

All submissions should refer to File Number SR-FINRA-2019-012 and should be submitted on or before [insert date 21 days from publication in the Federal Register]. If comments are received, any rebuttal comments should be submitted by [insert date 45 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>155</sup>

Jill M. Peterson  
Assistant Secretary

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<sup>155</sup> 17 CFR 200.30-3(a)(12); 17 CFR 200.30-3(a)(57).