

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-87855; File No. SR-FINRA-2019-012)

December 23, 2019

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Partial Amendment No. 2 and Order Granting Accelerated Approval of the Proposed Rule Change to Amend FINRA Rule 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements) to Make Substantive, Organizational, and Terminology Changes, as Modified by Partial Amendment No. 1 and Partial Amendment No. 2

I. Introduction

On April 11, 2019, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (the “Commission” or “SEC”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)¹ and Rule 19b-4 thereunder,² 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, 2019.³ 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.⁴ The Commission received six comment letters on the proposal.⁵ On July 11, 2019, FINRA

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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

⁴ See Securities Exchange Act Release No. 86091 (June 12, 2019), 84 FR 28371 (June 18, 2019).

⁵ See letter from Suzanne Rothwell, Managing Member, Rothwell Consulting LLC, to Secretary, Commission, dated May 14, 2019 (“Rothwell”); letter from Stuart J. Kaswell,

responded to the comments and filed Partial Amendment No. 1 to the proposal.⁶ On July 29, 2019, the Commission published Partial Amendment No. 1 for notice and comment and instituted proceedings pursuant to Section 19(b)(2)(B) of the Exchange Act⁷ to determine whether to approve or disapprove the proposed rule change, as modified by Partial Amendment No. 1.⁸ The Commission received three comment letters in response to the Order Instituting Proceedings.⁹ On October 28, 2019, the Commission extended the time period in which the Commission must approve or disapprove the proposed rule change, as amended by Partial Amendment No. 1.¹⁰ On November 8, 2019, FINRA responded to the comments and filed

Esq., to Vanessa Countryman, Acting Director, Commission, dated May 17, 2019 (“Kaswell Letter No. 1”); 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 No. 1”); 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”).

⁶ See letter from Jeanette Wingler, Associate General Counsel, FINRA, to Vanessa Countryman, Secretary, Commission, dated July 11, 2019 (“FINRA Response No. 1”). Partial Amendment No. 1 is available at <https://www.finra.org/industry/rule-filings/sr-finra-2019-012>. See also Order Instituting Proceedings, *infra* note 8.

⁷ 15 U.S.C. 78s(b)(2)(B).

⁸ See Securities Exchange Act Release No. 8650977391 (July 29, 2019), 84 FR 37921 (August 2, 2019) (“Order Instituting Proceedings”).

⁹ See letter from Hardy Callcott and Joseph McLaughlin, to Vanessa Countryman, Secretary, Commission, dated August 14, 2019 (“Callcott”); letter from Stuart J. Kaswell, Law Office of Stuart J. Kaswell, LLC, to Jill M. Peterson, Assistant Secretary, Commission, dated August 16, 2019 (“Kaswell Letter No. 2”); and letter from Aseel Rabie, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, to Vanessa Countryman, Secretary, Commission, dated August 23, 2019 (“SIFMA Letter No. 2”).

¹⁰ See Securities Exchange Act Release No. 87407 (October 28, 2019), 84 FR 58794 (November 1, 2019).

Partial Amendment No. 2 to the proposal.¹¹ This order provides notice of filing of Partial Amendment No. 2 and approves the proposal, as modified by Partial Amendments No. 1 and No. 2, on an accelerated basis.

II. Description of the Proposed Rule Change

Below is a description of FINRA’s proposal as modified by Partial Amendment No. 1, followed by a description of Partial Amendment No. 2.

A. Proposed Rule Change as Modified by Partial Amendment No. 1¹²

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. FINRA states that these changes should lessen the regulatory costs and burdens incurred when complying with the Rule.

¹¹ See letter from Jeanette Wingler, Associate General Counsel, FINRA, to Vanessa Countryman, Secretary, Commission, dated November 8, 2019 (“FINRA Response No. 2”). Partial Amendment No. 2 is available at <https://www.finra.org/industry/rule-filings/sr-finra-2019-012>. See also Section II.B *infra*.

¹² For a more detailed description of the proposed rule change as modified by Partial Amendment No. 1, see Notice, *supra* note 3, and Order Instituting Proceedings, *supra* note 8. See also Partial Amendment No. 1 available at <https://www.finra.org/sites/default/files/2019-07/sr-finra-2019-012-amendment-no1.pdf>.

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.¹³

FINRA also proposes to clarify and reduce filing requirements by directing members to provide SEC document identification number if available.¹⁴ FINRA proposes to require filing: (1) industry-standard master forms of agreement only if specifically requested to do so by FINRA;¹⁵ (2) amendments to previously filed documents only if there have been changes relating to the disclosures that impact the underwriting terms and arrangements for the public offering in those documents;¹⁶ (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”;¹⁷ and (4) an estimate of the maximum value for each item of underwriting compensation.¹⁸

Proposed Rule 5110(a)(4)(B)(iv) would 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.¹⁹

¹³ See proposed Rule 5110(a)(3)(A).

¹⁴ See proposed Rule 5110(a)(4)(A).

¹⁵ See proposed Rule 5110(a)(4)(A)(ii).

¹⁶ See proposed Rule 5110(a)(4)(A)(iii).

¹⁷ See proposed Rule 5110(a)(4)(B)(iii) and proposed Rule 5110(j)(7).

¹⁸ See proposed Rule 5110(a)(4)(B)(ii).

¹⁹ See Order Instituting Proceedings, supra note 8, 84 FR at 37927-28, and Partial Amendment No. 1, supra note 6.

FINRA also proposes to make a number of other clarifications regarding filing requirements to FINRA.²⁰ For example, the proposed rule change would clarify that a member participating in an offering is not required to file with FINRA if the filing has been made by another member participating in the offering.²¹ In addition, rather than providing a non-exhaustive list of types of public offerings that are required to be filed, the proposed rule change would instead state that a public offering in which a member participates must be filed for review unless exempted by the Rule.²² The proposed rule change, moreover, would clarify the general standard that no member may engage in the distribution or sale of securities unless FINRA has provided an opinion that it has no objection to the proposed underwriting terms and arrangements.²³ The proposed rule change also would clarify that any member acting as a managing underwriter or in a similar capacity must notify the other members participating in the public offering if informed of an opinion by FINRA that the underwriting terms and arrangements are unfair and unreasonable and the proposed terms and arrangements have not been appropriately modified.²⁴

Further, 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

²⁰ 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.

²¹ See proposed Rule 5110(a)(3)(B). Participating members are responsible for filing public offerings with FINRA. While an issuer may file an offering with FINRA if a participating member has not yet been engaged, a participating member must assume filing responsibilities once it has been engaged.

²² See proposed Rule 5110(a)(2).

²³ See proposed Rule 5110(a)(1)(C).

²⁴ See proposed Rule 5110(a)(1)(B).

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.²⁵

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.²⁶

Public Offerings Exempt from Substantive and/or 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."²⁷ And 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).²⁸

²⁵ See proposed Rule 5110(a)(4)(C) and proposed Rule 5110(g)(5).

²⁶ See Notice, supra note 3, 84 FR at 18593-594.

²⁷ 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), 5110(h)(1)(C), and Notice, supra note 3, 84 FR at 18593-594.

²⁸ See proposed Rule 5110(a)(4)(E).

Moreover, in proposed Rule 5110(h)(1)(A), FINRA proposes to clarify that securities of banks that have qualifying outstanding debt securities are exempt from the filing requirement.²⁹ Further, in the same provision, FINRA proposes to clarify that Treasury securities would not qualify for an exemption. Accordingly, FINRA proposes to make clear that the exemption applies to “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).³⁰

FINRA also proposes to expand the current list of offerings that are exempt from both the filing requirements and substantive provisions of Rule 5110. Specifically, FINRA proposes to include from such exemptions 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.³¹ In addition, FINRA would also include in such exemptions tender offers by issuers for their own securities made pursuant to Rule 13e-4 under the Exchange Act.³²

In addition, FINRA proposes to reclassify three items from the offerings exempt from filing and rule compliance to offerings excluded from the definition of public offering. These

²⁹ See proposed Rule 5110(h)(1)(A).

³⁰ See Order Instituting Proceedings, supra note 8, 84 FR at 37926.

³¹ See proposed Rule 5110(h)(2)(E), (K) and (L).

³² See Order Instituting Proceedings, supra note 8, 84 FR at 37926, and Partial Amendment No. 1, supra note 6.

include: (1) 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.³³

Disclosure Requirements

FINRA states that the proposed rule change would retain the current requirements for itemized disclosure of underwriting compensation and for disclosing dollar amounts ascribed to each such item.³⁴ 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 securities acquired by the participating member (e.g., exercise terms, demand rights, piggyback registration rights, and lock-up periods).³⁵

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, underwriting compensation shall include finder’s fees, underwriter’s counsel fees and securities.”³⁶

³³ See proposed Rule 5110(j)(18) and Order Instituting Proceedings, supra note 8, 84 FR at 37922.

³⁴ 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.

³⁵ See proposed Supplementary Material .05 to Rule 5110.

³⁶ See proposed Rule 5110(j)(22).

Further, FINRA provides that payments and benefits received during the applicable review period would be considered in evaluating underwriting compensation. According to FINRA, 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 or similar document, 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. Accordingly, 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.³⁷

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

³⁷ 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.

compensation, with streamlining and clarifying modification.³⁸ According to FINRA, the proposed examples of payments or benefits that would be underwriting compensation are comparable to the list of items of value in the current Rule with some additional clarifying changes. For example, the proposed rule change would expand the current item of value related to reimbursement of expenses to provide that fees and expenses paid or reimbursed to, or paid on behalf of, the participating members, including but not limited to road show fees and expenses and due diligence expenses, would be underwriting compensation.³⁹ Consistent with current practice, the proposed rule change would also include in underwriting compensation non-cash compensation.⁴⁰

According to FINRA, the proposed examples of payments or benefits that would not be underwriting compensation include several new examples to provide greater clarity and to address questions raised by members. For instance, the proposed rule change would clarify that the following would not be considered underwriting compensation: (1) payments for records management and advisory services received by members in connection with some corporate reorganizations;⁴¹ (2) payment or reimbursement of legal costs resulting from a contractual breach or misrepresentation by the issuer;⁴² (3) securities acquired pursuant to a governmental or

³⁸ See proposed Supplementary Material .01 to Rule 5110.

³⁹ See proposed Supplementary Material .01(a)(2) to Rule 5110. See also proposed Supplementary Material .01(a)(3) and (4) to Rule 5110 which includes fees and expenses of participating members' counsel and finder's fees paid or reimbursed to, or paid on behalf of, the participating members (except for reimbursement of "blue sky" fees) as underwriting compensation.

⁴⁰ See proposed Supplementary Material .01(a)(14) to Rule 5110.

⁴¹ See proposed Supplementary Material .01(b)(3) to Rule 5110.

⁴² See proposed Supplementary Material .01(b)(4) to Rule 5110.

court approved proceeding or plan of reorganization as a result of action by the government or court (e.g., bankruptcy or tax court proceeding);⁴³ (4) non-convertible securities purchased by the participating member in a public offering at the public offering price during the review period;⁴⁴ (5) accountable expenses received pursuant to Rule 5110(g)(5)(A);⁴⁵ and (6) compensation received through an employee benefit plan that qualifies under Section 401 of the Internal Revenue Code or a similar plan.⁴⁶

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

⁴³ See proposed Supplementary Material .01(b)(22) to Rule 5110. .

⁴⁴ Specifically, FINRA proposes in 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...” See FINRA Response No. 1, supra note 6, at 19 n. 27.

⁴⁵ 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 Order Instituting Proceedings, supra note 8, 84 FR at 37926 n.61 and Partial Amendment No. 1, supra note 6.

⁴⁶ Specifically, 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...” See Order Instituting Proceedings, supra note 8, 84 FR at 37927, and Partial Amendment No. 1, supra note 6.

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, FINRA would consider the following factors, as well as any other relevant factors and circumstances, when considering 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.⁴⁷

Venture Capital Exceptions

FINRA states that the proposed rule change would modify, clarify, and expand the venture capital exceptions.⁴⁸ Specifically, the proposed rule change would no longer treat as

⁴⁷ See proposed Supplementary Material .04 to Rule 5110.

⁴⁸ 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"). See Notice, supra note 3.

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.⁴⁹ 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.⁵⁰

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.⁵¹ Further, FINRA proposes to condition the availability of these exceptions to require that the affiliate, directly or through a subsidiary it controls, be in the business of making investments or loans or is an entity that has been newly formed by such affiliate.⁵²

With respect to the current venture capital exception relating to private placements with institutional investors, the proposal would now clarify that the exception is available where the institutional investors participating in the offering are not affiliates of a FINRA member and

⁴⁹ See proposed Supplementary Material .01(b)(14) and (16-18).

⁵⁰ 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 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) and (16-18).

⁵¹ See proposed Rule 5110(d)(1) and (2).

⁵² Id.

purchase at least 51% of the total number of securities sold in the private placement at the same time and on the same terms.⁵³ In addition, the proposed rule change would raise the percentage that participating members in the aggregate may acquire from 20% to 40% of the securities sold in the private placement.⁵⁴ Further, the proposed rule change would expand the scope of the exception to include providing services for a private placement (rather than just acting as a placement agent).⁵⁵

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 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.⁵⁶

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

⁵³ See Notice, supra note 3, 84 FR at 18596-597.

⁵⁴ See proposed Rule 5110(d)(3)(C).

⁵⁵ See proposed Rule 5110(d)(3).

⁵⁶ See proposed Rule 5110(d)(4).

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.⁵⁷ FINRA would consider the factors in proposed Supplementary Material .02 in determining whether securities acquired in a transaction that occurs after the required filing date, but otherwise meets the requirements of a venture capital exception, may be excluded from underwriting compensation. Specifically, FINRA would consider the following factors, as well as any other relevant factors and circumstances: (1) the length of time between the date of filing of the registration statement or similar document and the date of the transaction in which securities were acquired; (2) the length of time between the date of the transaction in which the securities were acquired and the anticipated commencement of the public offering; and (3) the nature of the funding provided, including, but not limited to the issuer’s need for funding before the public offering.⁵⁸

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 instruments⁵⁹ acquired in a transaction unrelated to a public offering would not be underwriting compensation.⁶⁰ 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

⁵⁷ See Notice, supra note 3, 84 FR at 18597.

⁵⁸ See proposed Supplementary Material .02(a)-(c) to Rule 5110.

⁵⁹ 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.

⁶⁰ 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.⁶¹

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 5110.⁶²

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 date of commencement of sales of the public equity offering (rather than the date of effectiveness

⁶¹ See proposed Rule 5110(a)(4)(B)(iv)(a). FINRA states that, 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.

⁶² See, e.g., proposed Supplementary Material .06(a) to Rule 5110, proposed Rule 5110(c), and Notice, supra note 3.

of the prospectus).⁶³ 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 and arrangements of any acquisition of securities by a participating member.⁶⁴

FINRA proposes to add an 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-10.⁶⁵ Further, 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.⁶⁶ FINRA provides that, while these securities would not be considered underwriting compensation and, thus, not subject to the lock-up restriction, the exception would provide additional clarity with respect to these securities. Moreover, the proposed rule change would 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.⁶⁷

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.⁶⁸ Specifically, FINRA proposes that the lock-up restriction would not apply to derivative instruments acquired in connection with a hedging transaction related to the public offering and

⁶³ See proposed Rule 5110(e)(1)(A).

⁶⁴ See proposed Rule 5110(e)(1)(B).

⁶⁵ See proposed Rule 5110(e)(2)(A)(iii).

⁶⁶ See proposed Rule 5110(e)(2)(A)(vi).

⁶⁷ See proposed Rule 5110(e)(2)(A)(viii).

⁶⁸ See proposed Rule 5110(e)(2)(A)(iv).

at a fair price.⁶⁹ Moreover, 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).”⁷⁰ In addition, the transfer or sale of a security back to the issuer in a transaction exempt from registration with the SEC would not be subject to the lockup restriction.⁷¹ Further, current Rule 5110(g)(2)(A)(ii) would be modified 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.⁷²

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 the 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.⁷³

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.⁷⁴ For example, the proposed rule

⁶⁹ 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.

⁷⁰ See proposed Rule 5110(e)(2)(A)(ix). See also Order Instituting Proceedings, supra note 8, 84 FR at 37925, and Partial Amendment No. 1, supra note 6.

⁷¹ See proposed Rule 5110(e)(2)(B)(iii).

⁷² 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).

⁷³ See current Rule 5110(g)(2)(A)(viii).

⁷⁴ See proposed Rule 5110(g).

change would clarify the scope of relevant activities that would be deemed related to the public offering⁷⁵ and refer to the commencement of sales of the public offering (rather than the date of effectiveness) in relation to the receipt of underwriting compensation consisting of any option, warrant or convertible security with specified terms.⁷⁶ The proposal would also 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 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.⁷⁷ Finally, the proposed rule change would also simplify a provision that relates to payments made by an issuer to waive or terminate a ROFR to participate in a future capital-raising transaction.⁷⁸ The proposed rule change would, however, retain the prohibition on any non-cash payment or fee to waive or terminate a ROFR.⁷⁹

⁷⁵ See proposed Rule 5110(g)(11). Specifically, to clarify the scope, the proposed rule change would refer to “solicitation, marketing, distribution or sales of the offering” rather than the current “distribution or assisting in the distribution of the issue, or for the purpose of assisting in any way in connection with the underwriting.” See Notice, supra note 3, 84 FR at 18599 n. 63.

⁷⁶ See proposed Rule 5110(g)(8).

⁷⁷ See proposed Rule 5110(g)(4).

⁷⁸ See current Rule 5110(f)(2)(F)(i).

⁷⁹ See proposed Rule 5110(g)(7).

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 Rule 5110's defined terms. For example, FINRA proposes to consolidate the various provisions that address what constitutes underwriting compensation into a single, new definition of "underwriting compensation."⁸⁰ The proposed rule change also would eliminate the term "underwriter and related persons" and instead use the defined term "participating member."⁸¹ Further, the proposed rule change would move the definition of "public offering" from Rule 5121 to Rule 5110⁸² and would modify the definition to add "made in whole or in part in the United States" to clarify the jurisdictional scope of the

⁸⁰ See proposed Rule 5110(j)(22). FINRA proposes to define the term "underwriting compensation" 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, underwriting compensation shall include finder's fees, underwriter's counsel fees, and securities." See *id.*

⁸¹ 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, according to FINRA, 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 states its belief 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, according to FINRA, 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.

⁸² See proposed Rule 5110(j)(18). Rule 5121 would incorporate the definition in Rule 5110 by reference. See Rule 5121(f).

definition.⁸³ The proposed rule change would also move, without modification, the definition of “Net Offering Proceeds” from Rule 5110 to Rule 5121.⁸⁴

In addition, the proposed rule change would modernize Rule 5110’s language (e.g., by replacing references to specific securities exchanges to instead reference the definition of “national securities exchange” in the Exchange Act). Furthermore, according to FINRA, the proposed rule change would include new defined terms to provide greater predictability for members in applying the Rule (e.g., “experienced issuer,”⁸⁵ “equity-linked securities,”⁸⁶ “overallotment option”⁸⁷ and “review period”⁸⁸).

The proposed rule change, moreover, would incorporate the definition of “associated person”⁸⁹ in Article I, Section (rr) of the FINRA By-Laws. Also, the proposed rule change would provide that a bank is “a bank as defined in Section 3(a)(6) of the Exchange Act, a branch

⁸³ See proposed Rule 5110(j)(18). FINRA is also proposing to amend the defined term “public offering” in proposed Rule 5110(j)(18)(A) to update the reference to offerings pursuant to “Section 4(6)” of the Securities Act to refer instead to Section 4(a)(5) of the Securities Act. See Order Instituting Proceedings, supra note 8, 84 FR at 37927.

⁸⁴ See proposed Rule 5121(f)(9).

⁸⁵ As discussed supra, 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. (Alternatively, \$100 million or more aggregate market value of voting stock held by non-affiliates and an annual trading volume of at least three million shares). Issuers meeting this standard would be defined as “experienced issuers” and their public offerings would be exempt from filing, but subject to the substantive provisions of Rule 5110. See proposed Rule 5110(j)(6).

⁸⁶ See proposed Rule 5110(j)(7).

⁸⁷ See proposed Rule 5110(j)(14).

⁸⁸ See proposed Rule 5110(j)(20).

⁸⁹ See proposed Rule 5110(j)(1).

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.”⁹⁰ In addition, the proposed rule change would revise the issuer definition 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.”⁹¹

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.⁹²

B. Partial Amendment No. 2⁹³

In response to comments received in response to the Order Instituting Proceedings, FINRA filed Partial Amendment No. 2 to the proposed rule change, as modified by Partial Amendment No. 1.⁹⁴ Partial Amendment No. 2 would modify the proposed rule change, as modified by Amendment No. 1, as follows:

⁹⁰ See proposed Rule 5110(j)(2).

⁹¹ See proposed Rule 5110(j)(12).

⁹² See proposed Rule 5110(c). See also Notice, supra note 3, 84 FR at 18600.

⁹³ The description in this Item II.B is based on Partial Amendment No. 2, as filed by FINRA. See supra note 11.

⁹⁴ See id.

Filing Requirements

In Partial Amendment No. 2, FINRA proposes to change the beneficial ownership threshold with respect to the representation requirement in proposed Rule 5110(a)(4)(B)(iii) from 5% to 10%. Specifically, as modified by Partial Amendment No. 2, proposed Rule 5110(a)(4)(B)(iii) would now require the filing of “a representation as to whether any officer or director of the issuer and any beneficial owner of 10% or more of any class of the issuer’s equity and equity-linked securities is an associated person or affiliate of a participating member”.

Venture Capital Exception

In Partial Amendment No. 2, FINRA proposes new Supplementary Material .07 to Rule 5110 to expressly provide its interpretation that the determination of whether a securities acquisition may qualify for a venture capital exception from underwriting compensation is to be made at the time of the securities acquisition.⁹⁵

Investment Grade Debt Exemption

FINRA proposes to revise proposed Rule 5110(h)(1)(A) to add the term “foreign bank” to the list of entities that may rely on the investment grade exemption.

Definition of “Participate”

FINRA proposes to revise proposed Rule 5110(j)(16)(B) to delete the words “provided that another member or members is participating in the public offering.”

⁹⁵ Specifically, as proposed in Partial Amendment No. 2, proposed new Supplementary Material .07 to Rule 5110 would state “[t]he determination of whether a securities acquisition may be excluded from underwriting compensation pursuant to paragraph (d) is to be made at the time of the securities acquisition.” See Partial Amendment No. 2, supra note 11.

Underwriting Compensation

FINRA proposes to revise proposed Supplementary Material .01(a)(7) to provide that purchases of both convertible and non-convertible securities during the review period by a participating member in a public offering at the public offering price and on the same terms as all others that are not participating members not be underwriting compensation.⁹⁶

Further, FINRA proposes to revise proposed Supplementary Material .01(b)(21) to provide that securities acquired by a member firm acting as a bona fide market maker would not constitute underwriting compensation.⁹⁷

III. Discussion of Comments Received on the Proposed Rule Change and FINRA's Response

The Commission received a total of nine comments in response to the proposed rule change.⁹⁸ Six comment letters were received in response to the filing as originally proposed.⁹⁹ Subsequently, FINRA filed Partial Amendment No. 1 and a response to those comments.¹⁰⁰ The Commission thereafter received three comments in response to the Order Instituting

⁹⁶ Specifically, Supplementary Material .01(a)(7) would now provide that “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 any such securities purchased during the review period by a participating member in a public offering at the public offering price and on the same terms as all others purchasing in the public offering that are not participating members shall not be deemed underwriting compensation.”

⁹⁷ Specifically, Supplementary Material .01(a)(7) would now provide that underwriting compensation does not include “securities acquired in the secondary market by a participating member that is a broker-dealer in connection with the performance of bona fide customer facilitation activities and bona fide market making activities...”

⁹⁸ See supra notes 5 and 9.

⁹⁹ See supra note 5.

¹⁰⁰ See FINRA Response No. 1, supra note 6.

Proceedings.¹⁰¹ FINRA subsequently filed Partial Amendment No. 2 and a response to comments received in response to the Order Instituting Proceedings.¹⁰² Significant comments received and FINRA's responses are summarized below.

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.¹⁰³ As discussed below, one commenter expresses support of a proposed exemption, but otherwise does not comment on other aspects of the proposal.¹⁰⁴ In response, FINRA has proposed certain modifications to the initial proposal as described in detail below.

Two commenters believe excessive underwriting compensation should be addressed through disclosure to investors and that Rule 5110 is inconsistent with the Exchange Act and the Securities Act.¹⁰⁵ These commenters suggest eliminating Rule 5110 in its entirety, or amending it to require only disclosure of underwriting compensation. In response, FINRA states, among other things, 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.¹⁰⁶

¹⁰¹ See supra note 9.

¹⁰² See supra note 11.

¹⁰³ See ABA, Davis Polk, Rothwell, and SIFMA Letter No. 1, supra note 5.

¹⁰⁴ See CAI, supra note 5.

¹⁰⁵ See Kaswell Letter Nos. 1 and 2, and Callcott, supra notes 5, 9.

¹⁰⁶ See FINRA Response No. 1, supra note 6 at 2, and FINRA Response No. 2, supra note 11 at 5-6.

Filing Requirements

Three commenters state that several of the proposed filing requirements are unnecessary.¹⁰⁷ Namely, commenters argue that the following filing requirements should be eliminated or modified: (1) disclosure of holdings that are excluded from underwriting compensation;¹⁰⁸ (2) M&A and private placement engagement letters;¹⁰⁹ (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 and equity-linked securities is an associated person or affiliate of a participating member;¹¹⁰ (4) notification of underwriting compensation received in terminated or revised offerings;¹¹¹ and (5) a description of securities acquired in bona fide venture capital transactions.¹¹²

In response to commenters' concerns regarding disclosure of holdings that are excluded from underwriting compensation, FINRA proposes in 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.¹¹³

With respect to M&A and private placement engagement letters, FINRA states that it continues to believe that such letters should be required to be filed with FINRA so that it may

¹⁰⁷ See ABA, Davis Polk, and SIFMA Letter No. 1, supra note 5.

¹⁰⁸ See ABA, Davis Polk, and SIFMA Letter No. 1, supra note 5.

¹⁰⁹ See ABA, supra note 5. See also SIFMA Letter No. 2, supra note 9.

¹¹⁰ See ABA and SIFMA Letter No. 1, supra note 5, and SIFMA Letter No. 2, supra note 9.

¹¹¹ See ABA, Davis Polk, and SIFMA Letter No. 1, supra note 5.

¹¹² See ABA, Davis Polk, and SIFMA Letter No. 1, supra note 5.

¹¹³ See FINRA Response No. 1, supra note 6 at 3-4.

determine if they impact the underwriting terms and arrangements for the public offering.¹¹⁴ Further, in response to one commenter's concern that FINRA's Public Offering System does not mirror the requirements of the proposed Rule and requires filing of stand-alone M&A and private placement engagement letters otherwise not required by the Rule,¹¹⁵ FINRA responds by stating that proposed Rule 5110(a)(4)(A)(ii) requires filing an engagement letter with FINRA for review only when the engagement letter contains terms relevant to the underwriting terms and arrangements. FINRA states that engagement letters that do not contain terms relevant to the underwriting terms and arrangements would therefore not be required.¹¹⁶ FINRA further states that, if the proposed rule change is approved, FINRA's Public Offering System would be revised and administered consistent with proposed Rule 5110(a)(4)(A)(ii).¹¹⁷

In response to comments with respect to the representation requirement in proposed Rule 5110(a)(4)(B)(iii),¹¹⁸ FINRA proposes to increase the disclosure threshold of beneficial ownership from 5% to 10% or more of an entity's common or preferred equity.¹¹⁹ Specifically, in Partial Amendment No. 2, FINRA proposes to revise proposed Rule 5110(a)(4)(B)(iii) to require filing "a representation as to whether any officer or director of the issuer and any beneficial owner of 10% or more of any class of the issuer's equity and equity-linked securities is an associated person or affiliate of a participating member." FINRA states that this proposed

¹¹⁴ See FINRA Response No. 1, supra note 6 at 3.

¹¹⁵ See SIFMA Letter No. 2, supra note 9 at 3-5.

¹¹⁶ See FINRA Response No. 2, supra note 11 at 2-3.

¹¹⁷ See id.

¹¹⁸ See FINRA Response No. 1, supra note 6 at 4-5. See also ABA, Davis Polk, and SIFMA Letter No. 1, supra note 5. ABA and SIFMA suggest a 25% threshold, while Davis Polk suggests a 10% threshold. See also SIFMA Letter No. 2, supra note 9.

¹¹⁹ See FINRA Response No. 2, supra note 11 at 3.

amendment would provide greater flexibility to participating members in relation to beneficial ownership information while still requiring that participating members provide information needed to identify potential conflicts of interest.¹²⁰

Further, with respect to compensation received relating to revised or terminated public offerings, FINRA states that such underwriting compensation is relevant for purposes of evaluating compliance with Rule 5110 and for preventing a member from being compensated twice for the same services.¹²¹ In addition, 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).¹²²

In response to comments regarding description of securities acquired in bona fide venture capital transactions, FINRA proposes to retain the requirement. 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.¹²³

¹²⁰ See FINRA Response No. 2, supra note 11 at 3.

¹²¹ See FINRA Response No. 1, supra note 6 at 6.

¹²² Specifically, Supplementary Material .01(a)(13) would 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 No. 1, supra note 6 at 6 n.10.

¹²³ See FINRA Response No. 1, supra note 6 at 4.

Although most commenters suggest scaling back the filing requirements, one commenter suggests that FINRA withdraw a proposed exception from the filing requirement.¹²⁴ Specifically, the commenter proposes that the expansion of the “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.¹²⁵ Moreover, this and another commenter request additional clarification on the “seasoned issuer” exemption.¹²⁶ Specifically, one commenter seeks clarification regarding whether the issuer’s qualifying debt or preferred securities for purposes of the exemption must be issued and outstanding.¹²⁷ The other commenter requests clarification that the term “corporate issuer” in the exemption is not meant to exclude issuers if they are not organized in “corporate” form.¹²⁸

In response to commenters’ concerns, FINRA 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. Accordingly, FINRA proposes to revise 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

¹²⁴ See Rothwell, supra note 5.

¹²⁵ See id.

¹²⁶ See Rothwell and ABA, supra note 5.

¹²⁷ See Rothwell, supra note 5.

¹²⁸ See ABA, supra note 5.

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). In addition, FINRA states that it would interpret “corporate issuers” to include, among other entities, limited partnerships and limited liability companies.¹²⁹

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 that do not individually or in the aggregate exceed the lesser of: (1) \$50,000; and (2) 0.1% of the dollar amount of securities offered in the public offering.¹³⁰ The same commenter also suggests that nominal gifts and occasional meals or other business entertainment that are provided in accordance with the limits set forth in proposed Rule 5110(f)(2)(A) and (B) should not be required to be separately itemized and disclosed as underwriting compensation because the administrative costs and burdens would outweigh the benefits.¹³¹

In response, FINRA notes that it previously considered the Rule’s disclosure requirements and continues to believe that the current itemized approach to disclosure is appropriate.¹³² FINRA further states that a de minimis exception would inherently involve a participating member categorizing different forms of underwriting compensation and determining whether the specific category exceeds the de minimis threshold.¹³³

¹²⁹ See FINRA Response No. 1, supra note 6 at 14.

¹³⁰ See SIFMA Letter No. 1, supra note 5, and SIFMA Letter No. 2, supra note 9.

¹³¹ See SIFMA Letter No. 2, supra note 9.

¹³² See FINRA Response No. 1, supra note 6 at 7. See also FINRA Response No. 2, supra note 11 at 4-5.

¹³³ See FINRA Response No. 2, supra note 11 at 4-5.

FINRA also declines to revise its Rule per commenter's suggestion regarding nominal gifts and occasional meals or other business entertainment. FINRA states that the suggested change would not alter the current requirements for disclosing non-cash compensation because non-cash compensation in connection with a public offering has long been considered underwriting compensation under Rule 5110 and is disclosed to FINRA via a question in FINRA's electronic filing system for public offerings.¹³⁴

Valuation

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.¹³⁵ Commenters request alternative valuation methodologies on a case-by-case basis¹³⁶ and for unit securities.¹³⁷ 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.¹³⁸

In response, FINRA states that it 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.¹³⁹ FINRA also notes that it has previously provided guidance

¹³⁴ See id. at 5.

¹³⁵ See SIFMA Letter No. 1 and Rothwell, supra note 5.

¹³⁶ See SIFMA Letter No. 1, supra note 5 at 8.

¹³⁷ See Rothwell, supra note 5 at 12.

¹³⁸ See SIFMA Letter No. 1, supra note 5 at 8.

¹³⁹ See FINRA Response No. 1, supra note 6 at 8.

for valuing unit securities.¹⁴⁰ 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 derivative instrument shall not have a compensation value for purposes of determining underwriting compensation.”¹⁴¹

Venture Capital Exceptions

Commenters generally support the venture capital exceptions.¹⁴² One commenter, however, contends that the definition of “institutional investor”¹⁴³ renders the venture capital exception unworkable.¹⁴⁴ The commenter suggests that the definition should focus instead on whether a participating member manages the investor’s investments or otherwise controls or directs the investment decisions of the investor. Alternatively, the commenter suggests that the scope of those subject to the equity interest calculation be limited to the participating FINRA member firm and its affiliates (*i.e.*, the calculation should not include associated persons that are not otherwise “affiliates” of the member firm or immediate family of such associated persons).

¹⁴⁰ See id.

¹⁴¹ See id.

¹⁴² See Rothwell and SIFMA Letter No. 1, supra note 5.

¹⁴³ Proposed Rule 5110(j)(10) defines the term “institutional investor” to mean “any person that has an aggregate of at least \$50 million invested in securities in its portfolio or under management, including investments held by its wholly owned subsidiaries; provided that no participating members manage the institutional investor's investments or have an equity interest in the institutional investor, either individually or in the aggregate, that exceeds 5% for a publicly owned entity or 1% for a nonpublic entity.

¹⁴⁴ See SIFMA Letter No. 1, supra note 5.

Further, the commenter suggests that the co-investment exception¹⁴⁵ be expanded to include other highly regulated entities that purchase in the private offering under the same conditions, provided that, in each case, no participating member manages the entity's investments or otherwise controls or directs the management or policies of the entity.¹⁴⁶ Finally, 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 the exception at the time of the acquisition of the securities.¹⁴⁷

In response, FINRA declines to revise the definition of "institutional investor". FINRA believes that revising the definition as suggested to focus on controlling or directing investment decisions would insert uncertainty and subjectivity into the definition and that the current definition is more objective.¹⁴⁸ Moreover, because Rule 5110's venture capital exceptions are relied upon by members, FINRA does not agree that the institutional investor definition makes the venture capital exceptions unworkable.

As for the comment regarding expanding the venture capital exception to other highly regulated entities, FINRA states that it will assess how the exception is operating in practice and may in the future consider extending the exception to include co-investments with other highly

¹⁴⁵ According to FINRA, co-investment exception is a type of venture capital exception that applies to 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. See proposed Rule 5110(d)(4). See also Notice, supra note 3, 84 FR at 18612.

¹⁴⁶ See SIFMA Letter No. 1, supra note 5.

¹⁴⁷ See id. See also SIFMA Letter No. 2, supra note 9.

¹⁴⁸ See FINRA Response No. 1, supra note 6 at 9-10.

regulated entities on comparable terms.¹⁴⁹ In response to the request that the determination as to the availability of a venture capital exception be made at the time of the acquisition of the securities and based on the participating member’s knowledge at that time, FINRA proposes new Supplementary Material .07 to Rule 5110, which would provide that “[t]he determination of whether a securities acquisition may be excluded from underwriting compensation pursuant to paragraph (d) is to be made at the time of the securities acquisition.”¹⁵⁰

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 registered investment advisers who are participating members.¹⁵¹

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).”¹⁵² Due to conflicting views on the issue of follow-on offerings, however, FINRA states that it will retain the historical

¹⁴⁹ See FINRA Response No. 1, supra note 6 at 9.

¹⁵⁰ See FINRA Response No. 2, supra note 11 at 6-7. FINRA points out that a securities acquisition must be made prior to the required filing date to qualify for the venture capital exceptions; accordingly, proposed Rule 5110(d)(1)-(4) would retain the language “before the required filing date of the public offering” in the rule text to continue to require that the securities acquisition be made prior to the required filing date to qualify for a venture capital exception. See id. at 7.

¹⁵¹ See SIFMA Letter No. 1, supra note 5 at 6.

¹⁵² See FINRA Response No. 1, supra note 6 at 11.

approach of a 180-day lock-up period for both initial and follow-on public offerings.¹⁵³ FINRA notes that certain follow-on public offerings may qualify for other exemptions.¹⁵⁴ FINRA also notes that, with respect to registered investment advisers who are participating members, it would consider requests for exemptive relief from the lock-up restriction pursuant to Rule 5110(i).¹⁵⁵

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.¹⁵⁶

In response to the commenters' request for clarification, FINRA confirms the commenters' understanding regarding the restrictions on receipt of non-cash compensation.¹⁵⁷

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.¹⁵⁸ 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

¹⁵³ See id.

¹⁵⁴ See id.

¹⁵⁵ See id.

¹⁵⁶ See ABA, supra note 5 at 7, and SIFMA Letter No. 1, supra note 5 at 9.

¹⁵⁷ See FINRA Response No. 1, supra note 6 at 12.

¹⁵⁸ See ABA, supra note 5.

participating member for cause.¹⁵⁹ 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.¹⁶⁰

In response, FINRA declines to modify the Rule pursuant to the commenter’s suggestions.¹⁶¹ FINRA believes that receiving advisory or consulting fees for services provided in connection with a public offering that is not completed and, therefore, results in no capital being raised is an unreasonable term and arrangement for purposes of Rule 5110. It notes, however, that participating members may receive termination fees or a ROFR related to an offering that is not completed consistent with Rule 5110(g)(5).

Further, FINRA believes that reasonable due diligence by a participating member would generally detect whether an issuer who has hired persons primarily for the purpose of solicitation, marketing, distribution, or sales of the offering was not in compliance with Section 15(a) of the Exchange Act or Rule 3a4-1 under the Exchange Act and applicable state law. According to FINRA, however, it would consider whether the participating member knew, or

¹⁵⁹ See ABA, supra note 5 at 7-8.

¹⁶⁰ See id.

¹⁶¹ See FINRA Response No. 1, supra note 6 at 12-13.

reasonably should have known, that the issuer had hired such persons absent compliance with applicable federal or state securities laws in assessing any violation of Rule 5110(g)(11).

Exemptions from Filing and Substantive Requirements

Commenters are generally supportive of FINRA's proposal to exempt certain offerings from the filing requirements.¹⁶² One commenter, however, requests that FINRA expand the exemptions to include tender offers by issuers for their own securities under the Exchange Act.¹⁶³ In response to the comment, as discussed in Partial Amendment No. 1 and described above, FINRA proposes to amend Rule 5110(h)(2)(G) to include tender offers by issuers for their own securities.¹⁶⁴

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.¹⁶⁵ In response, as discussed in the Partial Amendment No. 1 and described above, FINRA proposes to amend the proposed definition of bank in Rule 5110(j)(2) to include "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."¹⁶⁶

In response to the Order Instituting Proceedings, one commenter states that it agrees with the proposed modification to the definition of bank, but further suggests that proposed Rule

¹⁶² See Rothwell, CAI, and ABA, supra note 5.

¹⁶³ See ABA, supra note 5 at 10.

¹⁶⁴ See FINRA Response No. 1, supra note 6 at 13-14.

¹⁶⁵ See ABA, supra note 5 at 10.

¹⁶⁶ See FINRA Response No. 1, supra note 6 at 15.

5110(h)(1)(A) also be amended to include “foreign bank” to avoid creating a new and burdensome requirement that foreign banks must apply to FINRA for an exemption before relying on the investment grade debt exemption from filing.¹⁶⁷ In response, FINRA proposes to revise Rule 5110(h)(1)(A) to add “foreign bank” to the list of entities that may rely on the exemption.¹⁶⁸

Four commenters express concern over the term “experienced issuer” in Rule 5110(j)(6) and suggested alternatives or requested clarification.¹⁶⁹ For example, commenters express concern that the proposal would eliminate SEC and FINRA’s past interpretive guidance relating to the term.¹⁷⁰ Further, one commenter specifically requests clarification regarding the extent to which member firms can rely on prior SEC and FINRA guidance and interpretation associated with the Form S-3 and F-10 eligibility requirements, including those related to determining aggregate market value and public float.¹⁷¹ Yet another commenter suggests revising the definition of “experienced issuer” to “explain the requirements that must be met to satisfy the ‘reporting history’ requirement.”¹⁷²

In response, FINRA states that it believes that the proposed definition of “experienced issuer” codifies standards currently in place and simplifies the analysis for the benefit of members.¹⁷³ FINRA also notes that any guidance and interpretation issued by the SEC or

¹⁶⁷ See SIFMA Letter No. 2, supra note 9 at 2.

¹⁶⁸ See FINRA Response No. 2, supra note 11 at 7-8.

¹⁶⁹ See ABA, Davis Polk, SIFMA Letter No. 1, and Rothwell, supra note 5.

¹⁷⁰ See id.

¹⁷¹ See SIFMA Letter No. 2, supra note 9 at 6-7.

¹⁷² See Rothwell, supra note 5 at 14.

¹⁷³ See FINRA Response No. 1, supra note 6 at 16.

FINRA relating to the term remain valid and illustrative,¹⁷⁴ including any guidance and interpretation on determining aggregate market value and public float issued by the SEC or FINRA at adoption of, or issued thereafter in connection with, the pre-1992 standards for Forms S-3 and F-3 and standards approved in 1991 for Form F-10.¹⁷⁵ Finally, FINRA states that “reporting history is commonly understood to mean that the issuer has filed all material required to be filed for the relevant period immediately preceding the filing of the registration statement.”¹⁷⁶

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 to provide ordinary services to an issuer and assist the issuer in preparing offering and other documents.¹⁷⁷

In response, FINRA disagrees with the suggested expansion of services that may be provided by the independent financial adviser.¹⁷⁸ According to FINRA, the commenter’s suggestion would represent a significant expansion on the scope of services that may be provided by an independent financial adviser. Moreover, if adopted, compensation for these expanded services would not be underwriting compensation under the Rule. FINRA notes that it had previously concluded that that the advisory or consulting services that an independent financial

¹⁷⁴ See id.

¹⁷⁵ FINRA further states that the proposed defined term is intended for simplification only, and incorporation of the standards into the proposed defined term would not alter the scope of public offerings subject to Rule 5110. See FINRA Response No. 2, supra note 11 at 8.

¹⁷⁶ See FINRA Response No. 1, supra note 6 at 15.

¹⁷⁷ See Rothwell, supra note 5 at 14-15.

¹⁷⁸ See FINRA Response No. 1, supra note 6 at 17.

adviser may provide minimizes the risk of the imposition of unfair or unreasonable terms and arrangements on issuers.

Four commenters seek clarification and/or suggest a variety of changes to the proposed definitions of “participate,” “issuer,” and “participating member”¹⁷⁹ Specifically, two commenters seek clarification on the extent of the “issuer” carve out from the definition of “participating member.”¹⁸⁰ One commenter suggests amending the proposed defined term “participate” to include additional detail on activities that are considered involvement in the distribution of an offering by adding “including solicitation, marketing, distribution or sales of the offering.”¹⁸¹ Additionally, two commenters suggest excluding certain broker activities from the definition of “participate,” such as acting as a broker for a selling shareholder in return for compensation consisting of customary brokerage commissions and under circumstances in which the broker does not use special selling efforts and selling methods.¹⁸² Finally, one commenter states that it does not believe that an independent financial adviser that is not engaged in the solicitation or distribution of the offering should be deemed to be “participating” in a public offering – and thereby subject to the Rule’s filing and other requirements – solely because no other FINRA member is participating in the offering.¹⁸³

In response, FINRA states that the addition of “but does not include the issuer” to the definition of participating member is “intended to make clear that the ‘issuer’ as defined in

¹⁷⁹ See Rothwell, ABA, SIFMA Letter No. 1, and Davis Polk, supra note 5.

¹⁸⁰ See Rothwell and SIFMA Letter No. 1, supra note 5.

¹⁸¹ See Rothwell, supra note 5.

¹⁸² See ABA and Davis Polk, supra note 5.

¹⁸³ See SIFMA Letter No. 2, supra note 9.

proposed Rule 5110(j)(12) is entirely excluded from the proposed ‘participating member’ definition.”¹⁸⁴ Moreover, in Partial Amendment No. 1 and as described above, FINRA proposes to amend the defined term “issuer” to exclude a participating member, except where the participating member is offering its securities.

With respect to the term “participate,” while FINRA concedes that adding “including solicitation, marketing, distribution or sales of the offering” is illustrative, FINRA proposes to retain the current approach in the definition to accommodate a broad range of activities that may constitute participating in an offering.¹⁸⁵ Moreover, FINRA states that it does not agree with the commenters’ suggestion to create additional carve-outs from the definition of “participate” for certain brokerage activities, but notes that a participating members’ compensation for some activities may not be deemed underwriting compensation.¹⁸⁶

Finally, with respect to the suggested changes related to independent financial advisers, FINRA proposes to revise Rule 5110(j)(16)(B) to delete the words “provided that another member or members is participating in the public offering.” FINRA states that current Rule 5110 does not include this provision and that, accordingly, deleting the language will make the approach consistent with the current Rule.¹⁸⁷

Two commenters suggest that the defined term “public offering” in proposed Rule 5110(j)(18) should expressly exclude securities offered or sold by a broker-dealer pursuant to

¹⁸⁴ See FINRA Response No. 1, supra note 6 at 18.

¹⁸⁵ See FINRA Response No. 1, supra note 6 at 17.

¹⁸⁶ See id.

¹⁸⁷ See FINRA Response No. 2, supra note 11 at 9.

Sections 4(a)(3) and 4(a)(4) of the Securities Act.¹⁸⁸ FINRA declines to make the suggested revision, stating that members have not previously filed these offerings with FINRA and, consequently, FINRA has not received information on these offerings.¹⁸⁹

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 to Rule 5110.¹⁹⁰

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.¹⁹¹

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.¹⁹² One commenter is concerned that the

¹⁸⁸ See ABA, supra note 5 at 11, and SIFMA Letter No. 2, supra note 9 at 8-9. 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 and described above, FINRA proposes to revise the public offering definition's reference to these offerings as suggested by the commenter. See supra note 81.

¹⁸⁹ See FINRA Response No. 1, supra note 6 at 18.

¹⁹⁰ See ABA, Davis Polk, Rothwell, and SIFMA Letter No. 1, supra note 5.

¹⁹¹ See FINRA Response No. 1, supra note 6 at 19 n.27.

¹⁹² See ABA and SIFMA Letter No. 1, supra note 5.

proposed definition of “review period” expands the scope of the Rule and suggests that FINRA withdraw Supplementary Material .04.¹⁹³

In response to concerns regarding proposed Supplementary Material .04, FINRA states that proposed Supplementary Material .04 takes into account the price at which the securities are acquired. FINRA notes that, pursuant to proposed Supplementary Material .04, FINRA would consider, among other factors, 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.¹⁹⁴

Two commenters request clarification as to whether certain compensated parties would be considered “participating members” and thus their compensation be deemed underwriting compensation.¹⁹⁵ 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.¹⁹⁶ 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 a foreign distribution of an offering occurring in the U.S. and outside the U.S. simultaneously would not be deemed underwriting compensation under Rule 5110.¹⁹⁷

In response, FINRA confirms 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

¹⁹³ See Rothwell, supra note 5 at 1.

¹⁹⁴ See id.

¹⁹⁵ See SIFMA Letter No. 1 and Davis Polk, supra note 5.

¹⁹⁶ See SIFMA Letter No. 1, supra note 5 at 7-8.

¹⁹⁷ See Davis Polk, supra note 5 at 4.

underwriting compensation.¹⁹⁸ Further, FINRA provides 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 such separately allocated underwriting compensation to be outside the scope of Rule 5110 and not subject to the requirements of Rule 5110.¹⁹⁹

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 .01.²⁰⁰

In response, FINRA provides 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.²⁰¹

Underwriting Compensation

One commenter supports the changes in proposed Supplementary Material .01, which provides non-exhaustive lists of examples of payments or benefits that would or would not be underwriting compensation,²⁰² while others request that additional items be included to the list of items not deemed underwriting compensation.²⁰³ Specifically, commenters suggest the following be deemed not to constitute underwriting compensation: (1) the 1% valuation

¹⁹⁸ See FINRA Response No. 1, supra note 6 at 19-20.

¹⁹⁹ See FINRA Response No. 1, supra note 6 at 20.

²⁰⁰ See ABA, supra note 5 at 4-5.

²⁰¹ See FINRA Response No. 1, supra note 6 at 20.

²⁰² See Rothwell, supra note 5 at 2.

²⁰³ See ABA, Davis Polk, and SIFMA Letter No. 1, supra note 5.

assigned to ROFRs;²⁰⁴ (2) nominal gifts and occasional entertainment;²⁰⁵ (3) fees for services performed by participating members in the ordinary course of business unrelated to the distribution of the offering;²⁰⁶ and (4) 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.²⁰⁷

In response, FINRA disagrees with these suggestions and believes that such compensations should be reported to FINRA as underwriting compensation.²⁰⁸ With respect to 1% valuation assigned to ROFRs, FINRA maintains that ROFRs are a valuable benefit that traditionally have been used in combination with other forms of compensation to reward underwriters and that this historical approach to valuing ROFRs is reasonable. As for the suggestion pertaining to nominal gifts and occasional entertainment, FINRA responds that given the Rule's restrictions on the receipt of non-cash compensation, it expects such compensation to be nominal in practice, but that disclosure of non-cash compensation is needed for FINRA to have a complete understanding of underwriting compensation. Further, FINRA notes that the examples pertaining to payments or benefits received for services that may be considered unrelated to the public offering were added at the request of members for clarification and that the proposed scope of the examples is appropriate. Finally, with respect to compensation related

²⁰⁴ See SIFMA and ABA, supra note 5.

²⁰⁵ See ABA, supra note 5.

²⁰⁶ See Davis Polk, supra note 5. One commenter also requests that FINRA delete the words “to the issuer” from Supplementary Material .01(b)(4)-(6), given the construct of items in proposed Supplementary Material .01(b) and the definition of underwriting compensation in proposed Rule 5110(j)(22) covering payments from “any source.” See ABA, supra note 5.

²⁰⁷ See SIFMA Letter No. 1, supra note 5.

²⁰⁸ See FINRA Response No. 1, supra note 6 at 20-23.

to the issuance of one's own securities, FINRA states that, while rare, FINRA has seen potential violations of Rule 5110 in such offerings. Accordingly, FINRA declines to provide an exclusion of such instances from underwriting compensation.

In response to FINRA's proposal to expressly exclude non-convertible securities purchased by the participating member in a public offering at the public offering price during the review period from being deemed underwriting compensation, and to consider acquisitions of convertible securities by a participating member with negotiated or preferential terms under proposed Rule 5110(g)(8) as underwriting compensation,²⁰⁹ one commenter suggests modifying Supplementary Material .01(a)(7) to provide that any securities purchased during the review period by a participating member in a public offering at the public offering price and without any preferential terms shall not be deemed underwriting compensation.²¹⁰

In response, FINRA states that it is appropriate to interpret purchases of both convertible and non-convertible securities during the review period by a participating member in a public offering at the public offering price and on the same terms as all others that are not participating members not be underwriting compensation.²¹¹ FINRA thus proposes to adopt the suggestion in

²⁰⁹ In Partial Amendment No. 1, FINRA proposed to revise the Supplementary Material to expressly exclude non-convertible securities purchased by the participating member in a public offering at the public offering price during the review period from being deemed underwriting compensation under the proposal. In distinguishing between non-convertible and convertible securities, FINRA noted that it would consider acquisitions of convertible securities by a participating member with negotiated or preferential terms prohibited under proposed Rule 5110(g)(8) as underwriting compensation. See FINRA Response No. 2, supra note 11 at 10. See also Order Instituting Proceedings, supra note 8, 84 FR at 37927.

²¹⁰ See SIFMA Letter No. 2, supra note 9.

²¹¹ See FINRA Response No. 2, supra note 11 at 10. See also Order Instituting Proceedings, supra note 8, 84 FR at 37927.

substantive part, stating that the proposed amendment would instead incorporate the concept of purchases at the same price and with the same terms to provide objectivity and clarity.²¹²

FINRA explains that the concept of preferential treatment suggested by the commenter would require weighing and considering all of the various terms of a securities acquisition, which could be time consuming and would introduce uncertainty into the evaluation.²¹³

Three commenters suggest revising proposed Supplementary Material .01(b)(21) to expressly reference “bona fide market making activity” in the list of items not deemed as underwriting compensation under the proposed rule.²¹⁴ In response, as described above, FINRA proposes in Partial Amendment No. 2 to amend proposed Supplementary Material .01(b)(21) to expressly reference bona fide market making.²¹⁵

Two commenters suggest revising Supplementary Material .01(b)(14) to exclude from underwriting compensation securities acquired as the result of an “exercise” of securities that were originally acquired prior to the review period.²¹⁶ In response, FINRA states that, pursuant

²¹² See FINRA Response No. 2, supra note 11 at 10.

²¹³ See id. at 10-11.

²¹⁴ See ABA and Davis Polk, supra note 5, and SIFMA Letter No. 2, supra note 9.

²¹⁵ See FINRA Response No. 2, supra note 11 at 12. Specifically, the provision would be revised to state that underwriting compensation does not include “securities acquired in the secondary market by a participating member that is a broker-dealer in connection with the performance of bona fide customer facilitation activities and bona fide market making activities; provided that securities acquired from the issuer will be considered ‘underwriting compensation’ if the securities were not acquired at a fair price (taking into account, among other things customary commissions, mark-downs and other charges)...” See id.

²¹⁶ See ABA and Davis Polk, supra note 5.

to proposed Supplementary Material .01(b)(15), such securities would not be underwriting compensation.²¹⁷

Two commenters suggest that the exception in proposed Supplementary Material .01(b)(12) be expanded to include additional employee benefit plans.²¹⁸ In response to commenters' suggestions,²¹⁹ and as discussed in the Partial Amendment No. 1 and described above, FINRA proposes to revise Supplementary Material .01(b)(12) accordingly.²²⁰

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

Two commenters request clarification regarding the required participation by a qualified independent underwriter ("QIU").²²¹ In response, FINRA states that it has previously provided guidance regarding QIU participation pursuant to Rule 5121, and would be willing to consider requests for additional guidance on Rule 5121 separate from the proposal.²²²

IV. Discussion and Commission Findings

After careful review of the proposed rule change, the comment letters, and FINRA's response to the comments, the Commission finds that the rule change, as modified by Partial Amendments Nos. 1 and 2, is consistent with the requirements of the Exchange Act and the rules and regulations thereunder that are applicable to a national securities association.²²³ Specifically,

²¹⁷ See FINRA Response No. 1, supra note 6 at 21-22.

²¹⁸ See ABA and Davis Polk, supra note 5.

²¹⁹ See id.

²²⁰ See FINRA Response No. 1, supra note 6 at 22. See also supra note 44.

²²¹ See, e.g., SIFMA Letter No. 1, supra note 5 at 10, and ABA, supra note 5 at 8-9.

²²² See FINRA Response No. 1, supra note 6 at 23-24.

²²³ In approving this rule change, the Commission has considered the rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

the Commission finds that the rule change is consistent with Section 15A(b)(6) of the Exchange Act,²²⁴ which requires, among other things, that FINRA rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

FINRA states that the proposal seeks to modify Rule 5110 in an effort to modernize the Rule by, among other things, improving the administration of the Rule and simplifying the Rule's provisions while maintaining important protections for market participants, including issuers and investors participating in offerings. FINRA also provides that it engaged in extensive consultation with the industry to understand what aspects of the Rule needed to be modernized, simplified, and clarified. In sum, FINRA believes that the changes it proposes should lessen the regulatory costs and burdens incurred when complying with the Rule.

The Commission has carefully considered the proposed rule change, as modified by Partial Amendments Nos. 1 and 2, comment letters, and FINRA's response to the comments, and believes that the Rule as amended is reasonably designed to provide just and equitable principles of trade, while providing for protection of investors and the public interest consistent with Section 15A(b)(6) of the Exchange Act.²²⁵ Consequently, the Commission finds that the proposed rule change is designed to promote capital formation and aid member compliance efforts, while maintaining the integrity of the public offering process and investor confidence in the capital market.

²²⁴ 15 U.S.C. 78o-3(b)(6).

²²⁵ Id.

The Commission notes that a total of nine comments were received, and FINRA made a number of clarifications and modifications to the original proposal to address commenters' comments. The Commission notes that commenters, in general, supported FINRA's effort to modernize and streamline the Rule and recognized that the proposal would "make the Rule more efficient and provide members more certainty..."²²⁶ The Commission also recognizes that two commenters challenge the consistency of the Rule with the Exchange Act and the Securities Act.²²⁷ These commenters believe excessive underwriting compensation should be addressed through disclosure to investors and suggest eliminating Rule 5110 in its entirety or amending it to require only disclosure of underwriting compensation. Further, one commenter notes that FINRA does not identify or justify the amount of fees it collects under Rule 5110 and argues that "[o]n this basis alone, it is unclear how FINRA's Rule 5110 fees comply with the 1934 Act requirements that fees be reasonable and not impose an undue burden on competition."²²⁸

The Commission believes these comments are outside the scope of the proposed rule change. FINRA in the proposal seeks only to amend the Rule currently in place. Further, FINRA does not in this proposal seek to amend the fees related to the Rule.²²⁹ Accordingly, the Commission does not believe these comments can be appropriately addressed through this proposal.

The Commission believes that FINRA gave due consideration to the proposal and met the requirements of the Exchange Act. The Commission also believes that the proposal

²²⁶ See Davis Polk, supra note 5.

²²⁷ See Kaswell Letter Nos. 1 and 2 and Callcott, supra notes 5, 9.

²²⁸ See Callcott, supra note 9.

²²⁹ See also FINRA's responses to these comments, supra notes 6 and 11.

modernizes and streamlines the Rule for the benefit of the members subject to, and the investors affected by, the Rule. For the reasons stated above, the Commission finds that the proposed rule change is consistent with the Exchange Act and the rules and regulations thereunder.

V. Accelerated Approval of Proposed Rule Change, as Modified by Partial Amendments Nos. 1 and 2

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act, for approving the proposed rule change, as modified by Partial Amendment Nos. 1 and 2 thereto, prior to the 30th day after publication of Partial Amendment No. 2 in the Federal Register. Partial Amendment No. 2 responds specifically to comments received in response to the Order Instituting Proceedings and makes corresponding amendments to the proposal. These revisions specifically respond to comments received, add clarity to the proposal, and do not raise any novel regulatory concerns. Accordingly, the Commission finds that good cause exists to approve the proposal, as modified by Partial Amendment Nos. 1 and 2 on an accelerated basis.

VI. Solicitation of Comments on Partial Amendment No. 2

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended by Partial Amendment Nos. 1 and 2, is consistent with the Act. 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.

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 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change.

Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment 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].

VII. Conclusion

IT IS THEREFORE ORDERED pursuant to Exchange Act Section 19(b)(2)⁵³ that the proposal (SR-FINRA-2019-012), as modified by Partial Amendments Nos. 1 and 2, be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²³⁰

Eduardo A. Aleman
Deputy Secretary

²³⁰ 17 CFR 200.30-3(a)(12).