Recent Amendments to FINRA Corporate Financing Rule Now Effective

On March 20, 2020, the Financial Industry Regulatory Authority ("FINRA") issued a regulatory notice (the "Regulatory Notice")[1] describing amendments to its Rule 5110, also known as the "Corporate Financing Rule." FINRA has implemented substantive, organizational and terminology changes to Rule 5110 that aim to modernize, simplify and clarify the rule while maintaining key protections for market participants. Some provisions of the rule went into effect as of March 20, 2020, while other provisions became effective on September 16, 2020.[2] FINRA's Corporate Financing Department has published guidance on how the implementation date applies to new and amended filings on FINRA's website.[3]

I. Executive Summary

Key changes to Rule 5110:

- Filing Requirements: amends the filing requirements to extend the filing deadline, clarify and simplify the required documentation, raise the threshold for a required representation as to beneficial ownership of the issuer's securities, and add a required filing for underwriting compensation received in connection with a subsequently terminated offering;
- Shelf Offerings: codifies the rule's application to offerings by shelf-eligible issuers and simplifies the required filing for shelf offerings;
- Exemptions: clarifies the types of public offerings that are exempt from Rule 5110's filing requirements and expands the list of public offerings that are exempt from both Rule 5110's filing requirements and substantive requirements;
- Underwriting Compensation: consolidates multiple provisions into a single definition of "Underwriting Compensation," expands on the types of payments and benefits that constitute underwriting compensation, and establishes a "principles-based approach" for excluding certain securities received from third parties and through directed sales programs from underwriting compensation;
- Venture Capital Exceptions: removes the cap on purchases of the issuer's equity to qualify for the exception, raises the amount of securities that can be purchased in an issuer's private placements to institutional investors, creates a new exception for co-investments with certain regulated entities, and establishes a "principles-based approach" for excepting investments and funding provided to issuers during a significantly delayed offering;
- Non-Convertible Debt and Derivative Instruments: clarifies the rule's treatment of non-convertible or non-exchangeable debt securities and derivative instruments, including filing requirements, valuation for purposes of underwriting compensation, and lock-up restrictions;
- Lock-Up Restrictions: changes the commencement date for the lock-up restrictions from the date the prospectus becomes effective to the date that sales of the securities commence, expands the list of securities excepted from the lock-up restrictions, and modifies the restrictions to allow certain transactions among members and between members and the issuer;

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[1] For the full text of the release, see "FINRA Amends the FINRA Corporate Financing Rule" available at https://www.finra.org/rules-guidance/notices/20-10 (March 20, 2020) [hereinafter the "*Regulatory Notice*"]. Unless otherwise specified, all quoted statements in this memorandum are taken from the Regulatory Notice.

[2] The text of the fully amended rule is available at https://www.finra.org/rules-guidance/rulebooks/finra-rules/5110.

[3] See "Implementation Guidance for Public Offerings Subject to FINRA Rule 5110" available at https://www.finra.org/rules-guidance/key-topics/public-offerings/implementation-guidance-rule-5110 (September 20, 2020).

- Prohibited Terms: expands the list of underwriting terms and arrangements that are considered unfair.

II. Background

Since its adoption in 1992, FINRA Rule 5110 has aimed to prevent unfair underwriting terms in public offerings of securities. The rule requires members participating in public offerings[4] to file documents and information with FINRA regarding underwriting terms and arrangements. FINRA's Corporate Financing Department reviews these filings prior to commencement of the offering to ensure the underwriting terms meet the requirements of the applicable FINRA rules. A member may proceed with an offering only if FINRA provides an opinion that it has no objection to the underwriting terms and provisions.

FINRA has amended several of the provisions of Rule 5110, including reorganizing and clarifying the rule. Specifically, the amendments cover the following areas and provisions:

- filing requirements;
- shelf offerings;
- exemptions from filing requirements and substantive requirements;
- underwriting compensation;
- venture capital exceptions to underwriting compensation;
- treatment of non-convertible and non-exchangeable debt securities and derivatives;
- lock-up restrictions; and
- prohibited underwriting terms and arrangements.

The amendments to Rule 5110(a)(3)(A), Rule 5110(a)(4)(A)(ii) and Rule 5110(a)(4)(A)(iii) took effect March 20, 2020. Each of these amendments address the FINRA filing requirements and are discussed below. The remaining amendments to Rule 5110 took effect September 16, 2020.

III. Amendments

Filing Requirements – Rule 5110(a)

FINRA members are required to file documents and information with FINRA related to the underwriting terms and arrangements for a public offering of securities in which they are participating. FINRA amended the filing requirements for members participating in a public offering to make them clearer as well as to make the filing process easier and more efficient.

The amended rule extends the deadline for the required FINRA filing from one business day to three business days after filing with the Securities and Exchange Commission (the "SEC"), a state securities commission or other regulatory authority. The amendments also eliminate the need for members to file copies of certain documents that have already been filed with the SEC, instead allowing them to simply file the SEC document identification number. Examples of such documents include the registration statement, offering memorandum or other document used to offer the securities to the public, as well as all documents related to the underwriting terms, such as the underwriting agreement, purchase agreement, engagement letter or agreement among the underwriters.[5] The amended rule further reduces the required filing documentation by specifying that (i) participating members

[4] The amended Rule 5110 designates such members that participate in a public offering of securities as "participating members" in the new definitions section (Rule 5110(j)).

[5] FINRA Rule 5110(a)(4)(A).

need only file industry-standard master forms of agreement if specifically requested to do so by FINRA and (ii) marked pages of amendments to previously filed documents need only be filed if the changed pages relate to the underwriting terms.

Rule 5110(a)(4)(B)(iii) requires a representation regarding the participating member's beneficial ownership of the issuer's equity if it meets a certain threshold.[6] The amended rule raises this threshold so that such a representation is only required if the participating member and its associated persons beneficially own 10%, rather than 5%, or greater of the issuer's equity or equity-linked securities. This brings the threshold in line with Rule 5121's definition of "control," which also uses a 10% beneficial ownership threshold.[7]

In some circumstances, the amendments add to a participating member's filing obligations. The amended rule adds a provision that, where a participating member receives underwriting compensation for services rendered in connection with a public offering that is subsequently terminated, the participating member must still make a filing with FINRA to disclose that compensation. In the Regulatory Notice, FINRA states that it interprets this new provision (5110(a)(4)(C)) to require a filing whenever an agreement's termination provision is triggered and results in a participating member receiving underwriting compensation. FINRA would then consider the types of compensation received in assessing the participating member's compensation in any subsequent revised offering. Securities and other compensation received in the prior terminated offering are considered to be underwriting compensation for the revised offering, while accountable expenses from the prior offering can be excluded from underwriting compensation for the revised offering. Further, if a member does not participate in the revised offering, its compensation from the terminated offering is not counted towards the aggregate underwriting compensation for the revised offering.

Shelf Offerings – Rule 5110(a)(4)(E)

Historically, public filings by some shelf-eligible issuers have been exempt from Rule 5110's filing requirement while the public filings of other shelf-eligible issuers have been subject to the rule. The amended Rule 5110 seeks to codify the historical standards while also streamlining the filing process for the shelf offerings subject to the filing requirement. Rather than referring to the pre-1992 standards for Forms S-3 and F-3 and standards approved in 1991 for Form F-10, the amended rule adds a new defined term, "experienced issuer," to describe the shelf offerings that are exempt from the filing requirement. An experienced issuer is one that has (a) a 36-month SEC-reporting history and (b) either (i) at least $150 million aggregate market value of voting stock held by non-affiliates or (ii) at least $100 million aggregate market value of voting stock held by non-affiliates and an annual trading volume of three million shares or more in the stock.[8] Unless subject to another exemption, public offerings of shelf-eligible issuers that do not meet the definition of "experienced issuer" are subject to Rule 5110's filing requirement.

The amended rule streamlines the filing requirements for shelf offerings that remain subject to the rule by requiring only the filing of the Securities Act of 1933 (the "Securities Act") registration statement number and other

[6] FINRA Rule 5110(a)(4)(B)(iii).

[7] FINRA Rule 5121(f)(6)(A)(i).

[8] FINRA Rule 5110(j)(6). FINRA noted that the defined term is for simplification only and that it does not alter the scope of public offerings subject to Rule 5110. They consider any guidance and interpretation, including, without limitation, any guidance and interpretation on determining aggregate market value and public float previously issued by the SEC and FINRA in connection with the pre-1992 standards for Forms S-3 and F-3 and standards approved in 1991 for Form F-10, at adoption of such standards or thereafter, to be relevant for purposes of interpreting the new defined term. *Regulatory Notice* at 16.

information and documents requested by FINRA. Upon filing of the registration statement number, FINRA will provide its no objections opinion. FINRA will access the documents in the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system and populate the information necessary to conduct its review via FINRA's public offering system. Other information and documents will only need to be filed if requested by FINRA. To facilitate timely access to the capital markets, FINRA's review of documents and information related to a shelf takedown offering for compliance with Rule 5110 will occur on a post-takedown basis.

Exemptions From Filing and Substantive Requirements – Rule 5110(h)

There are two categories of public offerings that are exempt from Rule 5110: public offerings that are exempt from only the filing requirements of the rule (but remain subject to the substantive requirements) and public offerings that are exempt from both the filing requirements and the substantive requirements of the rule. For the first category, the amended rule clarifies that securities of domestic and foreign banks that have qualifying outstanding debt securities are exempt from the filing requirements. The amended rule also expands the list of public offerings that are exempt from both the filing and substantive requirements to include offerings of closed-end "tender offer" funds (closed-end funds that repurchase shares via tender offers), insurance contracts, unit investment trusts, and issuer self-tender offers (the exemption previously only covered tender offers by third parties).

Underwriting Compensation – Rule 5110(c) and (d)

The amended rule clarifies what does and does not constitute underwriting compensation. The amended rule eliminates the term "items of value" and consolidates several provisions into a single definition of "underwriting compensation." Underwriting compensation is defined as "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."[9] The definition goes on to include "finder's fees, underwriter's counsel fees and securities."[10] Although the concept of "items of value" has been removed, the amended rule continues to include two non-exhaustive lists of examples of payments and benefits that are and are not considered underwriting compensation, including examples of payments or benefits that were or were not previously considered "items of value" and several new examples. The examples reflect that payments and benefits will generally not be considered underwriting compensation if (i) they are received for services unrelated to the public offering, are consistent with those received by other similarly situated persons and are customary and appropriate for the services provided or (ii) if they were received in connection with bona fide financing or investing activities that are unrelated to the public offering and were not intended to provide underwriting compensation to a participating member. Securities acquired in a transaction where the terms of a transaction were altered to grant the participating member additional compensation during the review period or where only the participating member is offered an opportunity to invest are given as examples of an intent to provide underwriting compensation.

The amended rule also adds a definition of "review period," which varies based on the type of offering (firm commitment offering, best efforts offering, or firm commitment or best efforts takedown, or any other continuous offering made pursuant to Securities Act Rule 415).[11] Any payment that falls under the definition of underwriting compensation and occurs during the applicable review period will face a rebuttable presumption that it is underwriting compensation for that public offering.

[9] FINRA Rule 5110 (j)(22).

[10] *Id.*

[11] FINRA Rule 5110(j)(20).

In the Regulatory Notice, FINRA states that it will take a "principles-based approach" in determining whether securities of the issuer acquired from third parties or in directed sales programs (commonly called "friends and family" programs) during the review period should be excluded from underwriting compensation. This approach will start with the presumption that all issuer securities received during the review period are underwriting compensation, but it will take into account several factors described in the Supplementary Material to Rule 5110 in determining whether such securities should be excluded.[12] For securities acquired from third parties, these factors include the nature of the relationship between the issuer and the third party, the nature of the transactions in which the securities were acquired (including whether the participating member engages in the transactions as part of its ordinary course of business), and any disparity between the price paid by the third party and the offering or market price, as well as any other relevant factors or circumstances.[13] For securities acquired through directed sales programs, these factors include the existence of a pre-existing relationship between the issuer and the person acquiring the securities, the nature of the relationship, and whether the securities were acquired on the same terms and at the same price as other similarly-situated persons participating in the program, as well as any other relevant factors or circumstances.[14]

Venture Capital Exceptions to Underwriting Compensation – Rule 5110(d)

Rule 5110 includes several exceptions from underwriting compensation for bona fide venture capital transactions.[15] The exceptions are subject to various restrictions.[16] The amended rule modifies and expands on these exceptions.

Two prior exceptions, one for securities acquisitions and conversions to prevent dilution and the other for securities purchases based on a prior investment history, have been removed as exceptions and moved to the non-exhaustive list of items not considered to be underwriting compensation.

The amended rule broadens the exceptions relating to purchases and loans by certain affiliates and investments in and loans to certain issuers by removing the limitation on acquiring more than 25% of the issuer's total equity securities. In addition, the amendment revises the requirement in these exceptions that the participating member's affiliate must be primarily in the business of making investments or loans by providing that the affiliate can be in such business through a subsidiary it controls and the subsidiary may be an entity that is newly formed by the affiliate. The amended rule raises the total amount of securities that participating members may acquire in a private placement by the issuer with institutional investors from 20 to 40%, provided that at least 51% of the total securities sold in the private placement are purchased on the same terms by institutional investors that are not affiliates of participating members. Further, the amended rule creates a new venture capital exception to address co-investments with certain regulated entities. The new exception covers 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.[17]

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[12] *See also* Supplementary Material .03 and .04 at the end of FINRA Rule 5110.

[13] FINRA Rule 5110 Supplementary Material .03.

[14] FINRA Rule 5110 Supplementary Material .04.

[15] FINRA Rule 5110(d).

[16] *Id.*

[17] FINRA Rule 5110(d)(4).

The Regulatory Notice also states that FINRA will take a principles-based approach in determining whether funding provided to issuers during significantly delayed offerings should be considered underwriting compensation. FINRA is seeking to provide flexibility to members to make investments in the issuer during this delay period to satisfy the issuer's funding needs. As with securities acquired through third parties and directed sales programs, this approach will start with the presumption that the venture capital exception is not available where the investments are made after the required filing date, but it will consider several factors described in the Supplementary Material to Rule 5110 to determine 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. These factors include the length of time between the filing of the registration statement or similar document and the date the securities were acquired, the length of time between the date the securities were acquired and the anticipated commencement of the public offering and the nature of the funding transaction, including consideration of the issuer's need for funding before the public offering commences, as well as any other relevant factors or circumstances.[18]

Treatment of Non-Convertible or Non-Exchangeable Debt Securities and Derivatives – Rule 5110(a)(4)(B)(iv)

In the amended Rule 5110, FINRA clarifies its treatment of non-convertible or non-exchangeable debt securities and derivative instruments.[19] Non-convertible or non-exchangeable debt securities and derivative instruments that are acquired in a transaction *unrelated* to a public offering are not considered underwriting compensation and are not subject to Rule 5110. In such circumstances, there is no requirement to file a description of the securities with FINRA, and the securities are not subject to any valuation-related requirements or lock-up restrictions. Non-convertible or non-exchangeable debt securities and derivative instruments acquired in a transaction *related* to a public offering are considered underwriting compensation and are subject to the rule. The participating member must file a description of these securities with FINRA together with a representation that the transaction was conducted at a "fair price." If the transaction was at a fair price, the securities are considered to be underwriting compensation, but they are assigned no compensation value for purposes of determining the total underwriting compensation amount.[20] Securities acquired at a fair price are also excepted from the lock-up restrictions. If the transaction was not at a fair price, then the securities are considered to be underwriting compensation and are subject to the valuation requirements of Rule 5110(c) and the lock-up restrictions of Rule 5110(e).

Lock-Up Restrictions – Rule 5110(e)

Rule 5110(e) imposes a 180-day lock-up restriction on securities that are considered underwriting compensation.[21] Participating members are precluded from selling or transferring such securities as well as from pledging them as collateral, or making them subject to any derivative contract or other transaction that provides the effective economic benefit of a sale or other prohibited disposition of the securities.[22] The amended rule ensures the lock-up restriction is properly implemented by providing that the period begins on the date of commencement

[18] FINRA Rule 5110 Supplementary Material .02.

[19] Defined as any eligible over the counter derivative instrument as defined in Exchange Act Rule 3b-13(a)(1), (2) and (3).

[20] For a flow chart describing the treatment of non-convertible or non-exchangeable debt securities and derivatives, *see Regulatory Notice* at 13.

[21] FINRA Rule 5110(e).

[22] *See id.*

of sales of the public offering, rather than on the date the prospectus becomes effective. The amended rule also provides that the lockup restrictions must be disclosed in the prospectus or a similar disclosure document.

Further, the amended rule adds enumerated exceptions to the lock-up restrictions for clarity or where other regulations or market forces obviate the need for the restrictions. The amended rule also modifies the lock-up restrictions (i) to permit the transfer or sale of securities back to the issuer in a transaction exempt from registration with the SEC, (ii) to permit the transfer of securities to other participating members, their officers or partners, or their registered persons or affiliates, so long as all transferred securities remain subject to the lock-up restrictions for the remainder of the lock-up period, and (iii) to clarify the treatment of non-convertible or non-exchangeable debt securities and derivative instruments, as described above.

Prohibited Underwriting Terms and Arrangements – Rule 5110(g)

The amended Rule 5110 provides clarifications and amendments to the list of prohibited underwriting terms and arrangements, including:

- a clarification that the following are exceptions to the prohibition on the payment of any underwriting compensation prior to the commencement of sales of the public offering: (1) "an advance against accountable expenses actually anticipated to be incurred, which must be reimbursed to the issuer to the extent not actually incurred;" and (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;"
- a simplification of the provision relating to payments made by the issuer to waive or terminate a right of first refusal to participate in a future financing so that it only applies to any such payment that is not paid in cash; and
- a reference to the commencement of sales of the public offering (rather than the date of effectiveness) regarding the timing of receipt of underwriting compensation consisting of any option, warrant or convertible security with specified terms.

IV. Conclusion

With the amendments to Rule 5110, FINRA has sought to modernize, clarify and simplify the rules, while maintaining protections for market participants including issuers and the investing public. The amendments reorganize the rule, add new defined terms to increase clarity, expand provisions on required documentation and information and simplify the FINRA filing process.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email William Miller at 212.701.3836 or wmiller@cahill.com; Meghan McDermott at 212.701.3619 or mmcdermott@cahill.com; Mary Stokinger at 212.701.3430 or mstokinger@cahill.com; Bruna Amaral at 212.701.3389 or bamaral@cahill.com; or Michael Kiley at 212.701.3530 or mkiley@cahill.com or email publications@cahill.com.