

Regulatory Notice

12-27

Corporate Financing Rule

FINRA Requests Comment on Proposed Amendments to FINRA Rule 5110 Regarding Deferred Compensation Arrangements in Public Offerings

Comment Period Expires: July 23, 2012

Executive Summary

FINRA is requesting comments on proposed amendments to FINRA Rule 5110 (Corporate Financing Rule) that address current deferred compensation arrangements for financial advisory services in connection with public offerings, eliminate an anomalous filing requirement for exchange traded funds structured as statutory or grantor trusts, and make certain ministerial amendments to, among other things, reflect electronic filing requirements.

The text of the proposed rule change is set forth in Attachment A.

Questions regarding this *Notice* may be directed to:

- ▶ Joseph E. Price, Senior Vice President, Corporate Financing/Advertising Regulation, at (240) 386-4623;
- ▶ Paul Mathews, Director, Corporate Financing Department, at (240) 386-4639; or
- ▶ Lisa Jones Toms, Associate Director and Senior Counsel, Corporate Financing Department, at (240) 386-4661.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by July 23, 2012.

June 2012

Notice Type

- ▶ Request for Comment

Suggested Routing

- ▶ Compliance
- ▶ Corporate Finance
- ▶ Legal
- ▶ Senior Management

Key Topics

- ▶ Deferred Compensation Arrangements in Public Offerings
- ▶ Exemption for Exchange-Traded Fund Offerings

Referenced Rules & Notices

- ▶ FINRA Rule 5110
- ▶ NASD Rule 2830
- ▶ NTM 97-82



Financial Industry Regulatory Authority

Member firms and other interested parties can submit their comments using the following methods:

- ▶ Emailing comments to pubcom@finra.org; or
- ▶ Mailing comments in hard copy to:

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. Generally, FINRA will post comments as they are received.¹

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).²

Background and Discussion

A. Deferred Compensation Arrangements

The Corporate Financing Rule requires member firms to file with FINRA's Corporate Financing Department documents and information about the underwriting terms and arrangements in public offerings in which they will participate. Before a public offering is filed, investment banks may enter into engagement letters with issuers for underwriting and financial advisory services, and these engagement letters often have provisions that allow issuers to defer payment until after the completion of a capital-raising transaction (deferred compensation arrangement). A deferred compensation arrangement responds to issuer concerns that up-front payment for financial advisory services could adversely affect the issuer's business. To address the risks that an issuer having received financial advisory services might unreasonably cancel an engagement to avoid the deferred compensation payment, engagement letters often provide for termination fees (sometimes called tail fees) or rights of first refusal. A termination fee permits an underwriter to receive fees if its services are terminated and the issuer consummates a similar transaction with another underwriter in lieu of the transaction subject to the engagement letter. A right of first refusal (ROFR) grants an underwriter the right to act in an agreed upon capacity in a subsequent financing transaction. Both arrangements provide issuers and underwriters with greater flexibility to negotiate deferred compensation arrangements.

The Corporate Financing Rule only permits termination fees in exchange offers or similar transactions in which substantial structuring and advisory services beyond traditional underwriting and distribution services have been provided.³ The rule permits ROFRs, but the staff has interpreted the rule to prohibit ROFRs when a member's participation in the original transaction is terminated.⁴ The restrictions on the establishment of termination fees and ROFRs in the Corporate Financing Rule may unnecessarily interfere with the ability of issuers and underwriters to negotiate deferred or other appropriate compensation arrangements that may be better suited to the issuer's business interests. For this reason, FINRA proposes to amend the Corporate Financing Rule to permit termination fees and ROFRs in a wider set of circumstances.⁵

FINRA proposes to amend Rule 5110(f)(2)(D) to allow termination fees and ROFRs when the written agreement between the issuer and underwriter specifies that:

- ▶ the amount of the termination fee must be reasonable in relation to the services contemplated in the agreement and fees arising from services provided under an ROFR must be customary for those type of services;
- ▶ the issuer has a right of "termination for cause," which includes the member's material failure to provide the services contemplated in the agreement; and
- ▶ an issuer's termination for cause eliminates any obligations with respect to any termination fee or ROFR.

The proposed amendments would retain the requirements in the existing rule that termination fees can only be paid and ROFRs can be executed within certain time periods. The proposed amendments thus would require that an offering or other transaction described in the agreement must be consummated within two years of the date the engagement is terminated, and would continue to prohibit any ROFR with a duration of more than three years from the date of effectiveness or commencement of sales of a public offering.⁶ These time limitations will help ensure that the issuer is not subject to a termination fee or ROFR even after its business and operations may have significantly changed.

B. Filing Requirements for Certain Exchange-Traded Funds

Most exchange-traded funds (ETFs) are structured as open-end investment companies or unit investment trusts (UITs) that offer redeemable securities. Investment companies and UITs are exempt from regulation under the Corporate Financing Rule and are not required to be filed with FINRA's Corporate Financing Department. However, some ETFs are structured as Delaware statutory trusts or grantor trusts. The portfolio assets in these trusts typically are commodities, currencies or other assets that are not securities. Currently, there is no exemption for public offerings of ETFs structured in this manner and therefore these offerings are required to be filed under the rule.

The provisions in the Corporate Financing Rule regarding underwriting terms and arrangements are not designed for the ETF distribution methodology by which a “basket” of the underlying assets is deposited into the ETF’s portfolio and “creation units” of shares are provided to the broker-dealer in return. ETFs should be treated consistently, without regard to the chosen legal structure, which is dictated primarily by the nature of the assets in the portfolios rather than differences in distribution methods or underwriting terms and arrangements. Accordingly, the proposed amendments would exempt from the rule’s filing requirement offerings of securities issued by ETFs formed as grantor or statutory trusts in which the portfolio assets include commodities, currencies or other assets that are not securities.

C. Administrative Changes

FINRA proposes to make certain ministerial amendments to certain provisions in the Corporate Financing Rule to, among other things, reflect the acceptance of electronic filings.

Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See [NTM 03-73](#) (November 2003) (NASD Announces Online Availability of Comments) for more information.
2. See SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.
3. See Rule 5110(f)(2)(E).
4. See Rule 5110(f)(2), (F) & (G).
5. If an underwriter does not meet the requirements of proposed Rule 5110(f)(2)(D)(ii), then it would continue to be prohibited from receiving compensation for underwriting services in a terminated offering except for reimbursement of out-of-pocket accountable expenses.
6. Currently, Rule 5110(f)(2)(E) requires that the issuer consummate a transaction similar to the transaction contemplated in the agreement between the issuer and the underwriter within two years of termination of the agreement.

Attachment A

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5110. Corporate Financing Rule — Underwriting Terms and Arrangements

(a) No Change.

(b) Filing Requirements

(1) through (4) No Change.

(5) Documents to be Filed

(A) The following documents relating to all proposed public offerings of securities that are required to be filed under paragraph (b)(4) above shall be filed [with] through FINRA's electronic filing system for review:

(i) [Three copies of t]The registration statement, offering circular, offering memorandum, notification of filing, notice of intention, application for conversion and/or any other document used to offer securities to the public;

(ii) [Three copies of a]Any proposed underwriting agreement, agreement among underwriters, selected dealers agreement, agency agreement, purchase agreement, letter of intent, consulting agreement, partnership agreement, underwriter's warrant agreement, escrow agreement, and any other document that describes the underwriting or other arrangements in connection with or related to the distribution, and the terms and conditions relating thereto; and any other information or documents that may be material to or part of the said arrangements, terms and conditions and that may have a bearing on FINRA's review;

(iii) [Three copies of e]Each pre- and post-effective amendment to the registration statement or other offering document, [one] with a copy marked to show changes; and [three (3) copies of] any other amended document previously filed pursuant to subparagraphs (i) and (ii) above, [one] with a copy marked to show changes; and

(iv) [Three copies of t]The final registration statement declared effective by the SEC or equivalent final offering document and a list of the members of the underwriting syndicate, if not indicated therein, and one copy of the executed form of the final underwriting documents and any other document submitted to FINRA for review.

(B) [All d] Documents that are filed with the SEC through the SEC's Electronic Data Gathering, Analysis, and Retrieval ("EDGAR") System that are referenced in FINRA's electronic filing system shall be treated as filed with FINRA.

(6) No Change.

(7) Offerings Exempt from Filing

Notwithstanding the provisions of subparagraph (1) above, documents and information related to the following public offerings need not be filed with FINRA for review, unless subject to the provisions of Rule 5121(a)(2). However, it shall be deemed a violation of this Rule or Rule 2310, for a member to participate in any way in such public offerings if the underwriting or other arrangements in connection with the offering are not in compliance with this Rule or Rule 2310, as applicable:

(A) through (E) No Change.

(F) exchange offers of securities where:

(i) the securities to be issued or the securities of the company being acquired are listed on The Nasdaq Global Market, the New York Stock Exchange, or the American Stock Exchange; or

(ii) the company issuing securities qualifies to register securities with the SEC on registration statement Forms S-3, F-3, or F-10, pursuant to the standards for those Forms as set forth in subparagraphs (C)(i) and (ii) of this paragraph; [and]

(G) offerings of securities by a church or other charitable institution that is exempt from SEC registration pursuant to Section 3(a)(4) of the Securities Act[.]; and

(H) offerings of securities issued by an exchange-traded fund formed as a grantor trust or statutory trust in which the portfolio assets include commodities, currencies or other assets that are not securities.

(8) through (9) No Change.

(c) Underwriting Compensation and Arrangements

(1) No Change.

(2) Amount of Underwriting Compensation

(A) No Change.

(B) For purposes of determining the amount of underwriting compensation, all items of value received or to be received from any source by the underwriter and related persons which are deemed to be in connection with or related to the distribution of the public offering as determined pursuant to subparagraph[s] (3) [and (4)] below shall be included.

(C) through (D) No Change.

(3) No Change.

(d) through (e) No Change.

(f) Unreasonable Terms and Arrangements

(1) No Change.

(2) Prohibited Arrangements

Without limiting the foregoing, the following terms and arrangements, when proposed in connection with a public offering of securities, shall be unfair and unreasonable.

(A) Any accountable expense allowance granted by an issuer to the underwriter and related persons that includes payment for general overhead, salaries, supplies, or similar expenses of the underwriter incur[]red in the normal conduct of business.

(B) through (C) No Change.

(D) [The payment of a] Any compensation by an issuer to a member or person associated with a member in connection with an offering of securities that is not completed according to the terms of agreement between the issuer and underwriter, except: [those negotiated and paid in connection with a transaction that occurs in lieu of the proposed offering as a result of the efforts of the underwriter and related persons and provided, however, that]

(i) the reimbursement of out-of-pocket accountable expenses actually incurred by the member or person associated with a member[shall not be presumed to be unfair or unreasonable under normal circumstances.];

(ii) a termination fee or a right of first refusal, as set forth in a written agreement between the issuer and the member, provided that the agreement specifies:

a. the amount of any termination fee must be reasonable in relation to the services contemplated in the agreement and any fees arising from services provided under a right of first refusal must be customary for those type of services;

b. the issuer has a right of “termination for cause,” which shall include the member’s material failure to provide the services contemplated in the agreement;

c. an issuer’s “termination for cause” eliminates any obligations with respect to any termination fee or right of first refusal; and

d. the termination fee requires that in order for the issuer to be responsible for paying the fee, an offering or other transaction (as set forth in the agreement) must be consummated within two years of the date the engagement is terminated by the issuer.

[(E) Any “tail fee” arrangement granted to the underwriter and related persons that has a duration of more than two years from the date the member’s services are terminated, in the event that the offering is not completed in accordance with the agreement between the issuer and the underwriter and the issuer subsequently consummates a similar transaction, except that a member may demonstrate on the basis of information satisfactory to FINRA that an arrangement of more than two years is not unfair or unreasonable under the circumstances.]

[(F)E] Any right of first refusal provided to the underwriter or related persons to underwrite or participate in future public offerings, private placements or other financings that:

(i) has a duration of more than three years from the [date of effectiveness or] commencement of sales of the public offering or the termination date of the engagement between the issuer and underwriter; or

(ii) has more than one opportunity to waive or terminate the right of first refusal in consideration of any payment or fee;

([G]F) Any payment or fee to waive or terminate a right of first refusal regarding future public offerings, private placements or other financings provided to the underwriter and related persons that:

(i) has a value in excess of the greater of 1% of the offering proceeds in the public offering where the right of first refusal was granted (or an amount in excess of 1% if additional compensation is available under the compensation guideline of the original offering) or 5% of the underwriting discount or commission paid in connection with the future financing (including any overallotment option that may be exercised), regardless of whether the payment or fee is negotiated at the time of or subsequent to the original public offering; or

(ii) is not paid in cash.

(H) through (I) redesignated as (G) through (H).

([J]I) When proposed in connection with the distribution of a public offering of securities on a “firm commitment” basis, any over[] allotment option providing for the over[] allotment of more than 15% of the amount of securities being offered, computed excluding any securities offered pursuant to the over[] allotment option.

(K) through (L) redesignated as (J) through (K).

[(M) For a member or person associated with a member to participate in a public offering of real estate investment trust securities, as defined in NASD Rule 2340(c)(4), unless the trustee will disclose in each annual report distributed to investors pursuant to Section 13(a) of the Exchange Act a per share estimated value of the trust securities, the method by which it was developed, and the date of the data used to develop the estimated value.]

(g) Lock-Up Restriction on Securities

(1) No change.

(2) Exceptions to Lock-Up Restriction

(A)(i) through (ii) No Change.

(iii) if the aggregate amount of securities of the issuer held by the underwriter [or] and related persons do not exceed 1% of the securities being offered;

(iv) through (viii) No Change.

(B) No Change.

(h) Non-Cash Compensation

(1) No Change.

(2) Restrictions on Non-Cash Compensation

(A) through (B) No Change.

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not conditioned by the member on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by paragraph ([d]h)(2)(D);

(ii) through (iii) No Change.

(iv) the payment or reimbursement by the issuer or affiliate of the issuer is not conditioned by the issuer or an affiliate of the issuer on the achievement of a sales target or any other non-cash compensation arrangement permitted by paragraph ([d]h)(2)(D).

(D) No Change.

(E) Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, provided that the arrangement meets the criteria in paragraph ([d]h)(2)(D).

A member shall maintain records of all non-cash compensation received by the member or its associated persons in arrangements permitted by paragraphs ([d]h)(2)(C) through (E). The records shall include: the names of the offerors, non-members or other members making the non-cash compensation contributions; the names of the associated persons participating in the arrangements; the nature and value of non-cash compensation received; the location of training and education meetings; and any other information that proves compliance by the member and its associated persons with paragraphs ([d]h)(2)(C) through (E).

(i) No Change.

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