No written comments were solicited or received with respect to the proposed rule change.

I. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change is effective upon filing pursuant to Section 19(b)(3)(A)24 of the Act and subparagraph (f)(2) of Rule 19b–425 thereunder, because it establishes a due, fee, or other charge imposed by the Exchange.

At any time within 60 days of the filing of such proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings under Section 19(b)(2)(B)26 of the Act to determine whether the proposed rule change should be approved or disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change 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 email to rule-comments@sec.gov. Please include File Number SR–NYSECHX–2019–27 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–NYSECHX–2019–27 on the subject line.

SECURITIES AND EXCHANGE COMMISSION


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

December 23, 2019.

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, 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, 2019.2 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.3 The Commission received six comment letters on the proposal.4 On July 11, 2019, FINRA responded to the comments and filed Partial Amendment No. 1 to the proposal.5 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 Act6 to determine whether to approve or disapprove the proposed rule change, as modified by Partial Amendment No. 1.7 The Commission received three comment letters in response to the Order Instituting Proceedings.8 On October 28, 2019, the

5 See letter from Suzanne Rothwell, Managing Member, Rothwell Consulting LLC, to Secretary, Commission, dated May 14, 2019 (“Rothwell”); letter from Stuart J. Kaswell, Esq., to Vanessa Countryman, Acting Secretary, Commission, dated July 11, 2019 (“Kaswell Letter No. 1”); letter from Davis Polk & Wardwell LLP, on behalf of the Committee of Annuity Insurers, to Brent J. Fields, Secretary, Commission, dated May 21, 2019 (“CAI”); letter from Ansel Rабée, 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, MBA 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/se-fina-2019-012. See also Order Instituting Proceedings, infra note 8.
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
Commission extended the time period in which the Commission must approve or disapprove the proposed rule change, as amended by Partial Amendment No. 1. On November 8, 2019, FINRA responded to the comments and filed Partial Amendment No. 2 to the proposal. 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. 1

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.

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.

FINRA also proposes to clarify and reduce filing requirements by directing members to provide SEC document identification number if available. FINRA proposes to require filing: (1) Industry-standard master forms of agreement only if specifically requested to do so by FINRA; (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; (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”; and (4) an estimate of the maximum value for each item of underwriting compensation.

FINRA also proposes to make a number of other clarifications regarding filing requirements to FINRA. 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. 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. 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.

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.

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 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.

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.

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.” 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). 

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. 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 non-convertible debt with a term of issue of at least four years or unsecured non-convertible preferred securities that are investment grade rated, as defined in Rule 5121(f)(8), or are outstanding securities in the same series that have equal rights and obligations as investment grade rated securities, provided that an initial public offering of equity is required to be filed" (emphasis added). 

FINRA 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. In addition, FINRA would also include in such exemptions tender offers by issuers for their own securities that are exempt from the filing requirement.29 Further, in the same provision, FINRA proposes to make clear that the term "review period" as used in proposed Rule 5110(j)(18) and Order Instituting Proceedings, supra note 8, as well as in proposed Rule 5110(h)(2)(E), (K) and (L), would be underwriting compensation.30

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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 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. 

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. 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, or 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." 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 final closing of the offering; and (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.

The proposed rule change would continue to provide two non-exhaustive lists of examples of payments or benefits that would and would not be considered underwriting compensation, with streamlining and clarifying modification. 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. Consistent with current practice, the proposed rule change would also include in underwriting compensation non-cash compensation. 

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; (2) payment or reimbursement of legal costs resulting from a contractual breach resulting from a failure to comply with an agreement or contract; (3) money or services required as a condition of a loan; (4) any items of value received or to be received by a firm in connection with the sale of a firm commitment or best efforts takedown offering made under the Securities Act; (5) reimbursement of expenses paid to an underwriter or brokerdealer in connection with the sale of a firm commitment or best efforts takedown offering made pursuant to Rule 415 of the Securities Act; and (6) any items of value received or to be received by a firm in connection with the sale of a firm commitment or best efforts takedown offering made pursuant to Rule 415 of the Securities Act.

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

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. 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
or misrepresentation by the issuer; 42 (3) securities acquired pursuant to a governmental or 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 employment or 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 presumption that the issuer securities received during the review period would be underwriting compensation. However, where the relationship would qualify under Section 401 of the Internal Revenue Code, FINRA 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 transactions in which 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 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 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.\footnote{See proposed Rule 5110(d)(i).41} 

The proposed rule change would also provide some additional flexibility in the availability of the venture capital exceptions for securities acquired where the public offering has been significantly delayed. The proposed rule change would take a principles-based approach in considering whether it is appropriate to treat as underwriting compensation securities acquired by a member after the required filing date in a transaction that, except for the timing, would otherwise meet the requirements of a venture capital exception.\footnote{See Notice, supra note 3, 84 FR at 18597.} 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.\footnote{See proposed Supplementary Material .02(a)–(c) to Rule 5110.} 

Treatment of Non-convertible or Non-exchangeable Debt Securities and Derivatives

The proposed rule change would expressly provide that non-convertible or non-exchangeable debt securities and derivative instruments\footnote{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 4b–13(a)(1), (2) and (3) of the Exchange Act. See proposed Supplementary Material .06(b) to Rule 5110.}\footnote{See proposed Supplementary Material .01(b)(19) to Rule 5110.} acquired in a transaction unrelated to a public offering would not be underwriting compensation.\footnote{See proposed Rule 5110(d)(i).41} 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 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.\footnote{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 services 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.} 

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.\footnote{See proposed Rule 5110(a)(4)(B)(iv)(a).} 

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 of the prospectus).\footnote{See, e.g., proposed Supplementary Material .06(a) to Rule 5110, proposed Rule 5110(c), and Notice, supra note 3.} 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.\footnote{See proposed Rule 5110(e)(2)(B)(i). The proposed rule change would retain the current lock-up restriction for securities that are received as underwriting compensation and are registered and sold as part of a firm commitment offering. See proposed Rule 5110(e)(2)(B)(iii).} 

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.\footnote{See proposed Rule 5110(e)(2)(A)(i).} 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.\footnote{See proposed Rule 5110(e)(2)(A)(ii).} 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.\footnote{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 at a fair price. 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).” See also Order Instituting Proceedings, supra note 6, and Partial Amendment No. 1, Order Instituting Proceedings, supra note 6, at 37925, and Partial Amendment No. 1, Order Instituting Proceedings, supra note 6.} 

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 change would clarify the scope of relevant activities that would be deemed related to the public offering 75 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

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 5110 and modify the definition to add “made in whole or in part in the United States to clarify the jurisdictional scope of the 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 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

83 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(16).
B. Partial Amendment No. 2

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. Partial Amendment No. 2 would modify the proposed rule change, as modified by Amendment No. 1, as follows:

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.

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.”

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.

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.

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. Six comment letters were received in response to the filing as originally proposed. Subsequently, FINRA filed Partial Amendment No. 1 and a response to those comments. The Commission thereafter requested three comments in response to the Order Instituting Proceedings. FINRA subsequently filed Partial Amendment No. 2 in response to comments received in response to the Order Instituting Proceedings. 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. As discussed below, one commenter expresses support of a proposed exemption, but otherwise does not comment on other aspects of the proposal. 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. 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.

Filing Requirements

Three commenters state that several of the proposed filing requirements are unnecessary. Namely, commenters argue that the following filing requirements should be eliminated or modified: (1) Disclosure of holdings that are excluded from underwriting compensation; (2) M&A and private placement engagement letters; (3) a representation as to whether any officer or director of the issuer and any beneficial owner of 5% or more of any class of the issuer’s equity and equity-linked securities is an associated person or affiliate of a participating member; (4) notification of underwriting compensation received in terminated or revised offerings; and (5) a description of securities acquired in bona fide venture capital transactions.

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.\textsuperscript{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 determine if they impact the underwriting terms and arrangements for the public offering.\textsuperscript{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,\textsuperscript{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.\textsuperscript{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).

In response to comments with respect to the representation requirement in proposed Rule 5110(a)(4)(B)(iii),\textsuperscript{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.\textsuperscript{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 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.\textsuperscript{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.\textsuperscript{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).\textsuperscript{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.\textsuperscript{123} Although most commenters suggest scaling back the filing requirements, one commenter suggests that FINRA withdraw a proposed exception from the filing requirement.\textsuperscript{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.\textsuperscript{125} Moreover, this and another commenter request additional clarification on the “seasoned issuer” exemption.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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)(6), 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). In addition, FINRA states that it would interpret “corporate issuers” to include, among other entities, limited partnerships and limited liability companies.\textsuperscript{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.\textsuperscript{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.\textsuperscript{131}

In response, FINRA notes that it previously considered the Rule’s disclosure requirements and continues to believe that the current itemized

\textsuperscript{113} See FINRA Response No. 1, supra note 6 at 3–4.
\textsuperscript{114} See FINRA Response No. 1, supra note 6 at 3.
\textsuperscript{115} See SIFMA Letter No. 2, supra note 9 at 3–5.
\textsuperscript{116} See FINRA Response No. 2, supra note 11 at 2–3.
\textsuperscript{117} See id.
\textsuperscript{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.
\textsuperscript{119} See FINRA Response No. 2, supra note 11 at 3.
\textsuperscript{120} See FINRA Response No. 2, supra note 11 at 3.
\textsuperscript{121} See FINRA Response No. 1, supra note 6 at 6.
\textsuperscript{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.
\textsuperscript{123} See FINRA Response No. 1, supra note 6 at 4.
\textsuperscript{124} See Rothwell, supra note 5.
\textsuperscript{125} See supra note 5.
\textsuperscript{126} See Rothwell and ABA, supra note 5.
\textsuperscript{127} See Rothwell, supra note 5.
\textsuperscript{128} See ABA, supra note 5.
\textsuperscript{129} See FINRA Response No. 1, supra note 6 at 14.
\textsuperscript{130} See SIFMA Letter No. 1, supra note 5, and SIFMA Letter No. 2, supra note 9.
\textsuperscript{131} See SIFMA Letter No. 2, supra note 9.
approach to disclosure is appropriate.\textsuperscript{132} FINRA further states that a \textit{de minimis} exception would inherently involve a participating member categorizing different forms of underwriting compensation and determining whether the specific category exceeds the \textit{de minimis} threshold.\textsuperscript{133} 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.\textsuperscript{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.\textsuperscript{135} Commenters request alternative valuation methodologies on a case-by-case basis\textsuperscript{136} and for unit securities.\textsuperscript{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.\textsuperscript{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.\textsuperscript{139} FINRA also notes that it has previously provided guidance for valuing unit securities.\textsuperscript{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 “any 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.”\textsuperscript{141}

Venture Capital Exceptions

Commenters generally support the venture capital exceptions.\textsuperscript{142} One commenter, however, contends that the definition of “institutional investor” renders the venture capital exception unworkable.\textsuperscript{143} 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 be 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). Further, the commenter suggests that the co-investment exception 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.\textsuperscript{144} 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.\textsuperscript{145}

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.\textsuperscript{146} 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 regulated entities on comparable terms.\textsuperscript{147} 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.”\textsuperscript{148}

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

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\textsuperscript{132} See FINRA Response No. 1, supra note 6 at 7. See also FINRA Response No. 2, supra note 11 at 4–5.

\textsuperscript{133} See FINRA Response No. 2, supra note 11 at 4–5.

\textsuperscript{134} See id. at 5.

\textsuperscript{135} See SIFMA Letter No. 1 and Rothwell, supra note 5.

\textsuperscript{136} See SIFMA Letter No. 1, supra note 5 at 8.

\textsuperscript{137} See Rothwell, supra note 5 at 12.

\textsuperscript{138} See SIFMA Letter No. 1, supra note 5 at 8.

\textsuperscript{139} See FINRA Response No. 1, supra note 6 at 8.

\textsuperscript{140} See id.

\textsuperscript{141} See id.

\textsuperscript{142} See Rothwell and SIFMA Letter No. 1, supra note 5.

\textsuperscript{143} Proposed Rule 5110(i)(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 member manages the institutional investor’s investments or have an equity interest in the institutional investor, or any individually or in the aggregate, that exceeds 5% for a publicly owned entity or 1% for a nonpublic entity. See SIFMA Letter No. 1, supra note 5.

\textsuperscript{144} 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.

\textsuperscript{145} See SIFMA Letter No. 1, supra note 5.

\textsuperscript{146} See id. See also SIFMA Letter No. 2, supra note 9.

\textsuperscript{147} See FINRA Response No. 1, supra note 6 at 9–10.

\textsuperscript{148} See FINRA Response No. 1, supra note 6 at 9.

\textsuperscript{149} 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.
investment advisers who are participating members.\textsuperscript{151}

In response, as discussed in Partial Amendment No. 1, FINRA proposes to add Rule 5110(o)(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).”\textsuperscript{152} Due to conflicting views on the issue of follow-on offerings, however, FINRA states that it will retain the historical approach of a 180-day lock-up period for both initial and follow-on public offerings.\textsuperscript{153} FINRA notes that certain follow-on public offerings may qualify for other exemptions.\textsuperscript{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).\textsuperscript{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.\textsuperscript{156}

In response to the commenters’ request for clarification, FINRA confirms the commenters’ understanding regarding the restrictions on receipt of non-cash compensation.\textsuperscript{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.\textsuperscript{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 participating member for cause.\textsuperscript{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.\textsuperscript{160}

In response, FINRA declines to modify the Rule pursuant to the commenter’s suggestions.\textsuperscript{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 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.\textsuperscript{162} One commenter, however, requests that FINRA expand the exemptions to include tender offers by issuers for their own securities under the Exchange Act.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.”\textsuperscript{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 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.\textsuperscript{167} In response, FINRA proposes to revise Rule 5110(b)(1)(A) to add “foreign bank” to the list of entities that may rely on the exemption.\textsuperscript{168}

Four commenters express concern over the term “experienced issuer” in Rule 5110(j)(6) and suggested alternatives or requested clarification.\textsuperscript{169} For example, commenters express concern that the proposal would eliminate SEC and FINRA’s past interpretive guidance relating to the term.\textsuperscript{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.\textsuperscript{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.”\textsuperscript{172}

In response, FINRA states that it believes that the proposed definition of

\textsuperscript{151} See SIFMA Letter No. 1, supra note 5 at 6.
\textsuperscript{152} See FINRA Response No. 1, supra note 6 at 11.
\textsuperscript{153} See id.
\textsuperscript{154} See id.
\textsuperscript{155} See id.
\textsuperscript{156} See ABA, supra note 5 at 7, and SIFMA Letter No. 1, supra note 5 at 9.
\textsuperscript{157} See FINRA Response No. 1, supra note 6 at 12.
\textsuperscript{158} See ABA, supra note 5.
\textsuperscript{159} See ABA, supra note 5 at 7–8.
\textsuperscript{160} See id.
\textsuperscript{161} See FINRA Response No. 1, supra note 6 at 12–13.
\textsuperscript{162} See Rothwell, CAI, and ABA, supra note 5.
\textsuperscript{163} See ABA, supra note 5 at 10.
\textsuperscript{164} See FINRA Response No. 1, supra note 6 at 13–14.
\textsuperscript{165} See ABA, supra note 5 at 10.
\textsuperscript{166} See FINRA Response No. 1, supra note 6 at 15.
\textsuperscript{167} See SIFMA Letter No. 2, supra note 9 at 2.
\textsuperscript{168} See FINRA Response No. 2, supra note 11 at 7–8.
\textsuperscript{169} See ABA, Davis Polk, SIFMA Letter No. 1, and Rothwell, supra note 5.
\textsuperscript{170} See id.
\textsuperscript{171} See SIFMA Letter No. 2, supra note 9 at 6–7.
\textsuperscript{172} See Rothwell, supra note 5 at 14.
“experienced issuer” codifies standards currently in place and simplifies the analysis for the benefit of members.\textsuperscript{173} FINRA also notes that any guidance and interpretation issued by the SEC or FINRA relating to the term remain valid and illustrative,\textsuperscript{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.\textsuperscript{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.”\textsuperscript{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.\textsuperscript{177} In response, FINRA disagrees with the suggested expansion of services that may be provided by the independent financial adviser.\textsuperscript{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 the advisory or consulting services that an independent financial 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.”\textsuperscript{179} Specifically, two commenters seek clarification on the extent of the “issuer” carve out from the definition of “participating member.”\textsuperscript{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.”\textsuperscript{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.\textsuperscript{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.\textsuperscript{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 proposed Rule 5110(j)(12) is entirely excluded from the proposed ‘participating member’ definition.”\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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 Sections 4(a)(3) and 4(a)(4) of the Securities Act.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{192} One commenter is concerned that the proposed definition of “review period” expands the scope of the Rule and

\textsuperscript{173} See FINRA Response No. 1, supra note 6 at 16.
\textsuperscript{174} See id.
\textsuperscript{175} See FINRA Response No. 1, supra note 6 at 15.
\textsuperscript{176} See Rothwell, supra note 5 at 14–15.
\textsuperscript{177} See FINRA Response No. 1, supra note 6 at 17.
\textsuperscript{178} See Rothwell, ABA, SIFMA Letter No. 1, and Davis Polk, supra note 5.
\textsuperscript{179} See Rothwell and SIFMA Letter No. 1, supra note 5.
\textsuperscript{180} See Rothwell, supra note 5.
\textsuperscript{181} See ABA and Davis Polk, supra note 5.
\textsuperscript{182} See SIFMA Letter No. 2, supra note 9.
\textsuperscript{183} See FINRA Response No. 1, supra note 6 at 18.
\textsuperscript{184} See FINRA Response No. 1, supra note 6 at 17.
\textsuperscript{185} See id.
\textsuperscript{186} See id.
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 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”

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

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 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 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

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.
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 “of 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.
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.
underwriting compensation.\footnote{211} FINRA thus proposes to adopt the suggestion in 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.\footnote{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.\footnote{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.\footnote{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.\footnote{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.\footnote{216} In response, FINRA states that, pursuant to proposed Supplementary Material .01(b)(15), such securities would not be underwriting compensation.\footnote{217}

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

Supplementary Material .01(b)(12) accordingly.\footnote{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").\footnote{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.\footnote{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.\footnote{223} Specifically, the Commission finds that the rule change is consistent with Section 15A(b)(6) of the Exchange Act,\footnote{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.\footnote{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.

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 . . . “.\footnote{226} The Commission also recognizes that two commenters challenge the consistency of the Rule with the Exchange Act and the Securities Act.\footnote{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.”\footnote{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.\footnote{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 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 email to 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 and should be submitted on or before January 21, 2020.

VII. Conclusion

It is therefore ordered pursuant to Exchange Act Section 19(b)(2) 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.

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SECURITIES AND EXCHANGE COMMISSION


Self-Regulatory Organizations; Cboe Exchange, Inc.; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change To Allow the Exchange To Continue To List Classes of Options on the MSCI Emerging Markets Index After January 1, 2020

December 23, 2019.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)3 and Rule 19b–4 thereunder,4 notice is hereby given that on December 12, 2019, Cboe Exchange, Inc. (“Exchange” or “Cboe Options”) filed with the Securities and Exchange Commission (“Commission”), the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and, for the reasons discussed below, is issuing this order approving the proposed rule change on an accelerated basis.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

Cboe Exchange, Inc. seeks approval from the Securities and Exchange Commission to continue listing classes of options on the MSCI EM Index.

The text of the proposed rule change is also available on the Exchange’s website (http://www.cboe.com/AboutCBOE/CBOELegalRegulatoryHome.aspx), at the Exchange’s Office of the Secretary, and at the Commission’s Public Reference Room.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to seek approval pursuant to Rule 4.10(i) for the continued listing of options on the EM Index (“EM Options”). Rule 4.10(i) establishes maintenance listing standards that apply to options on the EM Index5 and also provides that in the event a class of index options listed on the Exchange fails to satisfy the maintenance listing standards, the Exchange shall not open for trading any additional series of options of that class unless the continued listing of that class of index options has been approved by the Commission under Section 19(b)(2) of the Exchange Act. Specifically, Rule 4.10(i)(2), requires that the total number of component securities in the EM Index

5 As well as the MSCI EAFE, FTSE Emerging and FTSE Developed Europe indexes.