



**Jeanette Wingle**  
Associate General Counsel

Direct: (202) 728-8013  
Fax: (202) 728-8264

July 11, 2019

Ms. Vanessa Countryman  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-1090

**Re: File No. SR-FINRA-2019-012 (Proposed Rule Change to Amend FINRA Rule 5110 (Corporate Financing Rule - Underwriting Terms and Arrangements) to Make Substantive, Organizational and Terminology Changes)**

Dear Ms. Countryman:

This letter responds to comments received by the Securities and Exchange Commission (“SEC” or “Commission”) to the above-referenced rule filing (the “Proposal”) related to making substantive, organizational and terminology changes to FINRA Rule 5110 (Corporate Financing Rule - Underwriting Terms and Arrangements) (“Rule”). The Proposal is intended to modernize Rule 5110 and to simplify and clarify its provisions while maintaining important protections for market participants, including issuers and investors participating in offerings. The Proposal would also update cross-references and make other non-substantive changes within FINRA rules due to the proposed amendments to Rule 5110.

The Commission published the proposed rule change for public comment in the Federal Register on May 1, 2019,<sup>1</sup> and received six comments in response to the Proposal.<sup>2</sup> The following are FINRA’s responses, by topic, to the commenters’ material concerns.

---

<sup>1</sup> See Securities Exchange Act Release No. 85715 (April 25, 2019), 84 FR 18592 (May 1, 2019) (Notice of Filing of File No. SR-FINRA-2019-012).

<sup>2</sup> See Partial Amendment No. 1 for a list of comments received and abbreviations assigned to commenters.

### Overall Proposal

Four commenters supported FINRA's efforts to review, streamline and modernize the Rule for the benefit of market participants but offered suggested modifications as to some aspects of the Proposal.<sup>3</sup> As discussed below, CAI supported a proposed exemption, but did not comment on other aspects of the Proposal.

Kaswell stated that Rule 5110's restrictions on underwriting compensation in public offerings impose a burden on competition that is not consistent with the Securities Exchange Act of 1934 ("Exchange Act") and is inconsistent with the purposes of the Securities Act of 1933 ("Securities Act"). Instead of limiting underwriting compensation, Kaswell stated that excessive underwriting compensation should be addressed through disclosure to investors.

Disclosure of underwriting compensation is an important component of Rule 5110.<sup>4</sup> While disclosure is valuable to investors in assessing public offerings, disclosure alone is not sufficient to prohibit unfair underwriting terms and arrangements that disadvantage issuers and investors in public offerings of securities. The primary function of Rule 5110 is to protect issuers and their investors at the time of the public offering from unfair underwriting terms and arrangements. Unfair underwriting terms and arrangements increase capital raising costs, potentially leading to less efficient allocations of capital and restricting issuers' access to capital markets. Furthermore, the SEC's approval of the adoption of Rule 5110 in 1992 is an acknowledgement that additional protections—beyond disclosure—are needed to govern underwriting terms and arrangements. The additional protections of Rule 5110 play an important role in ensuring investor protection and market integrity through effective and efficient regulation that facilitates vibrant capital markets.

---

<sup>3</sup> See ABA, Davis Polk, Rothwell and SIFMA.

<sup>4</sup> The SEC's Regulation S-K requires fees and expenses identified by FINRA as underwriting compensation to be disclosed in the prospectus. Rule 5110 requires itemized disclosure of underwriting compensation, including dollar amounts ascribed to each such item. In addition, the Proposal would make explicit the existing practice of disclosing specified material terms and arrangements related to underwriting compensation in the prospectus (i.e., the provision would require a description for: (1) any right of first refusal ("ROFR") granted to a participating member and its duration; and (2) the material terms and arrangements of the securities acquired by the participating member (e.g., exercise terms, demand rights, piggyback registration rights and lock-up periods)). See proposed Supplementary Material .05 to Rule 5110.

### Filing Requirements

The Proposal would amend Rule 5110's filing requirements to create a process that is both more flexible and more efficient for members. Rothwell supported the proposed: (1) change to extend the period within which the documents must be filed with FINRA from one business day to three business days; (2) reduction of documents and information to be filed; and (3) streamlined filing process for qualifying shelf offerings.

Regardless of whether entered into during the review period, ABA and Davis Polk stated that Rule 5110 should provide that mergers and acquisitions ("M&A") and private placement engagement letters are not required to be filed with FINRA, unless the letter contains a ROFR for a future public offering (other than a ROFR that is limited to the issuer's initial public offering ("IPO")) or otherwise provides for securities-based compensation that may be deemed underwriting compensation for the public offering under review. Rule 5110 requires filing with FINRA documents that impact the underwriting terms and arrangements for the public offering, such as financing terms. Filing an engagement letter with FINRA for review is appropriate where the engagement letter contains terms relevant to the public offering being reviewed pursuant to Rule 5110. For example, a single engagement letter may govern different types of offerings (e.g., an engagement letter that covers a private placement and the public offering of the issuer's securities). In addition, an M&A or private placement engagement letter may contain terms that apply during the review period for the public offering (e.g., financing terms).

Commenters stated that proposed Rule 5110(a)(4)(B)(iv), which requires the filing of a "description of any securities of the issuer acquired and beneficially owned by any participating member during the review period," should be limited to a description of any securities-based underwriting compensation acquired during the review period by the participating member (i.e., no description for securities that do not constitute underwriting compensation).<sup>5</sup> Commenters stated that the provision would impose significant additional costs and administrative burdens on members and, due to likely fluctuations in holdings over the review period, would present compliance challenges.

A description of issuer securities acquired and beneficially owned by the participating member during the review period is needed to evaluate the underwriting terms and arrangements of the public offering and to ensure that there is no circumvention of the Rule. In response to the commenters' concerns and to reduce costs and administrative burdens on participating members, as discussed in the Partial Amendment No. 1, FINRA is proposing to revise Rule 5110(a)(4)(B)(iv) to not require filing a description of any securities acquired in accordance with

---

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

Supplementary Material .01(b), which sets forth a non-exhaustive list of payments that generally would not be deemed to be underwriting compensation. This approach would reduce filing burdens for members regarding payments and benefits that would not be considered underwriting compensation, while ensuring that FINRA receives adequate information about other issuer securities acquired and beneficially owned by the participating member during the review period to fully evaluate the underwriting terms and arrangements of the public offering and to ensure that there is no circumvention of the Rule.<sup>6</sup>

FINRA proposes to retain the requirement that a description be filed for any securities acquired in bona fide venture capital transactions as set forth in proposed Rule 5110(d) (for brevity, referred to herein as the “venture capital exceptions”). The exceptions are designed to distinguish securities acquired in bona fide venture capital transactions from those acquired as underwriting compensation. The venture capital exceptions include several restrictions to ensure the protection of other market participants and that the exceptions are not misused to circumvent the requirements of Rule 5110. Unless these restrictions are met, the securities are treated as underwriting compensation pursuant to Rule 5110. 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.

With respect to the representation requirement in proposed Rule 5110(a)(4)(B)(iii) where beneficial owners of 5 percent or more of any class of the issuer’s equity securities are funds or other types of investment vehicles, commenters suggested requiring a statement of association or affiliation only with respect to the general partner or investment manager of a fund or investment vehicle, and any limited partner beneficially owning more than 10 percent or 25 percent of the limited partnership or limited liability company membership interests of the fund or investment vehicle.<sup>7</sup> Commenters suggested that the approach would balance

---

<sup>6</sup> Specifically, Rule 5110(a)(4)(B)(iv) would be revised to: “(iv) a description of any securities of the issuer acquired and beneficially owned by any participating member during the review period, provided that: a. non-convertible or non-exchangeable debt securities and derivative instruments acquired in a transaction related to the public offering must be filed and also accompanied by a representation that a registered principal or senior manager of the participating member has determined if the transaction was or will be entered into at a fair price; [and] b. non-convertible or non-exchangeable debt securities and derivative instruments need not be filed if acquired in a transaction that is unrelated to the public offering[.]; and c. securities if acquired in accordance with Supplementary Material .01(b) need not be filed.”

<sup>7</sup> See ABA, Davis Polk and SIFMA. ABA and SIFMA suggested a 25 percent threshold. Davis Polk suggested a 10 percent threshold.

FINRA's interest in gathering information about potential conflicts with the difficulties in obtaining information as to limited partners who have no investment discretion or control over the fund's investments.

FINRA previously considered this issue in responding to comments received to Regulatory Notice 17-15 (April 2017) ("Notice 17-15 Proposal"). As previously explained in the Proposal, although application of Rule 5110's requirements to beneficial ownership by funds or other types of investment vehicles historically has not been problematic, there have been some instances where conflicts have been identified. When questions have arisen related to beneficial ownership by funds or other types of investment vehicles, FINRA has been willing to work with members to address the questions raised by particular structures and arrangements. Rather than amending the Rule, FINRA proposes to retain the flexibility afforded by this established approach because beneficial ownership of 5 percent or more of an issuer's securities may result in conflicts of interest.

ABA and Davis Polk do not support the proposed requirement to file a written notification to FINRA with respect to any underwriting compensation received by a participating member in connection with an offering that was filed with FINRA but that was ultimately not completed according to its terms.<sup>8</sup> The commenters stated that it was unclear when an offering would be deemed not to have been "completed according to the terms of an agreement entered into by the issuer and a participating member." The commenters also suggested that neither notification nor filing should be required in respect of items of compensation received in compliance with proposed Rule 5110(g)(4) and (g)(5).

As previously explained in the Proposal, underwriting compensation received or to be received in terminated offerings is relevant to FINRA's evaluation of compliance with Rule 5110 and, in particular, proposed paragraphs (g)(4) and (g)(5). The proposed requirement to file written notification with FINRA for any underwriting compensation received in an offering that is not completed would allow FINRA to provide more effective oversight when a member's services have been terminated. FINRA would interpret proposed Rule 5110(a)(4)(C) to require written notification to FINRA when an agreement's termination provision is triggered for a participating member or the offering. FINRA believes that a participating member is aware when an agreement's termination provision is triggered for the participating member or the offering (e.g., because the participating member may be entitled to termination fees) and, consequently, does not believe that the proposed requirement will be confusing in practice. Furthermore, FINRA will consider the information received pursuant to proposed Rule 5110(a)(4)(C) in assessing a participating member's participation in any revised public offering.

---

<sup>8</sup> See proposed Rule 5110(a)(4)(C).

Commenters stated that consideration of prior compensation received in a revised public offering is not appropriate, particularly if the compensation is received for services actually rendered or for out-of-pocket expenses actually incurred in connection with the prior offering that was not completed in compliance with the requirements of proposed Rule 5110(g)(4) and (g)(5).<sup>9</sup> Commenters stated that it is unclear: (1) what a “revised public offering” is; (2) whether the inclusion is limited solely to compensation received (or arrangements for compensation entered into) during the review period for the revised public offering; and (3) how proposed Supplementary Material .01(a)(13) relates to proposed Rule 5110(a)(4)(C) requiring notice to FINRA of compensation received for a prior offering that was not completed.

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

As the commenters noted, a participating member in a revised public offering may have received payment for accountable expenses in the prior offering that was not completed. As discussed in the Partial Amendment No. 1, FINRA believes that these expenses may be excluded from underwriting compensation in the revised public offering and, accordingly, is proposing to revise Supplementary Material .01(a)(13) to exclude from underwriting compensation accountable expenses received pursuant to Rule 5110(g)(5)(A).<sup>10</sup>

---

<sup>9</sup> See ABA, Davis Polk and SIFMA. SIFMA acknowledged that proposed Supplementary Material .01(a)(13), which provides that “underwriting compensation” includes “any compensation paid to any participating member in connection with a prior proposed public offering that was not completed, if the member firm participates in the revised public offering,” is consistent with a similar provision in the current Rule. See Rule 5110(c)(3)(A)(xiii).

<sup>10</sup> Specifically, Supplementary Material .01(a)(13) would be revised to provide that underwriting compensation would include “any compensation paid to any

### Disclosure

The Proposal would retain Rule 5110's current requirements for itemized disclosure of underwriting compensation and disclosing dollar amounts ascribed to each item.<sup>11</sup> The Proposal also would incorporate the requirements for disclosure of specified material terms and arrangements that are consistent with current practice.<sup>12</sup> SIFMA disagreed with this approach and stated that itemized disclosure of individual dollar amounts is not necessary or helpful to investors if the amount is immaterial in the context of the transaction. SIFMA suggested 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 percent of the dollar amount of securities offered in the public offering.

FINRA previously considered the Rule's disclosure requirements in responding to comments received to the Notice 17-15 Proposal. As previously explained in the Proposal, commenters had conflicting views on the proposed change in the Notice 17-15 Proposal to allow aggregation of underwriting compensation, with the North American Securities Administrators Association ("NASAA") stating that itemized disclosure may be beneficial for investors in better understanding the underwriting compensation paid and incentives that may be present in the public offering. Recognizing commenters' conflicting views, the Proposal retained the current requirements for itemized disclosure of underwriting compensation and disclosing dollar amounts ascribed to each such item. Furthermore, introducing a *de minimis* threshold below which itemized disclosure of underwriting compensation would not be required may result in purposeful division of underwriting compensation into amounts less than the threshold so as to avoid the itemized disclosure requirement.

### Valuation

Rule 5110 currently prescribes specific calculations for valuing convertible and non-convertible securities received as underwriting compensation. As discussed in the Proposal, commenters had conflicting views on the proposed change to the

---

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; and".

<sup>11</sup> See proposed Rule 5110(b)(1) and Supplementary Material .05 to Rule 5110. See also proposed Rule 5110(e)(1)(B) requiring disclosure of lock-ups.

<sup>12</sup> See proposed Supplementary Material .05 to Rule 5110.

valuation method in the Notice 17-15 Proposal to allow using a securities valuation method that is commercially available and appropriate for the type of securities to be valued. As a result, the Proposal retained the current methods for valuing options, warrants and other convertible securities received as underwriting compensation in the current Rule.<sup>13</sup>

SIFMA acknowledged the utility in having a standard valuation method for consistency, but urged FINRA to permit alternative valuation methodologies on a case-by-case basis. As noted above, commenters had conflicting views on the changes to the valuation method in the Notice 17-15 Proposal. In addition, commenters to the Notice 17-15 Proposal and the Proposal did not provide any information regarding the use of other commercially available valuation methods, such as what methods are available and their anticipated benefits. Without clarification of which alternative methods participating members intend to use and in which circumstances, FINRA proposes to retain the methods for valuing options, warrants and other convertible securities received as underwriting compensation in the current Rule. 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.

For purposes of clarification, SIFMA also requested that proposed Rule 5110(c)(3) contain an express exclusion for options and other derivatives acquired at a fair price. The requested clarification is set forth in proposed Rule 5110(c)(5), which states “[a]ny non-convertible or non-exchangeable debt or derivative instrument acquired or entered into at a ‘fair price’ as defined in Supplementary Material .06(b) and underwriting compensation received in or receivable in the settlement, exercise or other terms of such non-convertible or non-exchangeable debt or derivative instrument shall not have a compensation value for purposes of determining underwriting compensation.”

Rothwell suggested a reconsideration of her comment to the Notice 17-15 Proposal questioning the guidance in NASD Notice to Members 92-28 for valuing unit securities. Rothwell suggested an alternative valuation method for these securities. As discussed in the Proposal, FINRA previously provided guidance, with accompanying examples, for valuing unit securities. The guidance—contained in the Public Offering Acquisitions User Guide—references the longstanding guidance for valuing unit securities originally published in NASD Notice to Members 92-28.<sup>14</sup> The guidance remains valid and illustrative of FINRA’s method for valuing unit securities.

---

<sup>13</sup> See proposed Rule 5110(c).

<sup>14</sup> See FINRA Public Offering Acquisitions User Guide at <http://www.finra.org/sites/default/files/AppSupportDoc/p226879.pdf>.

### Venture Capital Exceptions

Recognizing that bona fide venture capital transactions contribute to capital formation, the Proposal would modify, clarify and expand the current venture capital exceptions to further facilitate members' participation in bona fide venture capital transactions. Importantly, the venture capital exceptions would include several restrictions to ensure the protection of other market participants and that the exceptions are not misused to circumvent the requirements of Rule 5110.

The Proposal would adopt a new venture capital exception from underwriting compensation for securities acquired in a private placement before the required filing date of the public offering by a participating member if at least 15 percent 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 (for brevity, the "co-investment exception").<sup>15</sup> Rothwell supported the proposed co-investment exception. SIFMA also supported the proposed exception but suggested expanding the exception 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.

If the conditions of the co-investment exception are met, securities acquired by the participating member in the private placement would not be deemed underwriting compensation under Rule 5110. As discussed in the Proposal, where a highly regulated mutual fund 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 securities acquired by the participating member in a private placement are less likely to be underwriting compensation. Moreover, the proposed conditions for the new co-investment exception lessen the risk that the co-investment would be made for the purpose of providing undervalued securities to a participating member in return for acting as an underwriter. If the SEC approves the Proposal, FINRA will assess how the co-investment exception is operating in practice and may consider extending the exception to include co-investments with other highly regulated entities on comparable terms.

SIFMA stated that the current definition of "institutional investor" for purposes of the venture capital exceptions is problematic and difficult to use. SIFMA stated that the focus of the definition should be on whether a participating member manages the investor's investments or otherwise controls or directs the investment decisions of the investor or, alternatively, the equity interest calculation scope should

---

<sup>15</sup> See proposed Rule 5110(d)(4).

be narrowed solely to the participating FINRA member and its affiliates to provide greater certainty and objectivity.

FINRA previously considered this issue in responding to comments received to the Notice 17-15 Proposal. As previously explained in the Proposal, revising the definition as suggested to focus on controlling or directing investment decisions would insert uncertainty and subjectivity into the definition. The Proposal retained this definition because the current definition is more objective. 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.

SIFMA also suggested that the venture capital exceptions should be clarified to provide that the determination as to the availability of an exception is to be made by the participating member at the time of the acquisition of the securities. FINRA previously considered this issue in responding to comments received to the Notice 17-15 Proposal. As previously explained in the Proposal, except for the principles-based approach for significantly delayed offerings, the venture capital exceptions apply to the acquisition of securities before the required filing date. Accordingly, whether an acquisition of the securities meets an exception must be determined before the required filing date.

#### Lock-Up Restriction

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 Proposal would add exceptions from the lock-up restriction for clarity or to except securities where other protections or market forces obviate the need for the restriction.

SIFMA suggested eliminating the lock-up restriction for offerings of securities that are "actively-traded" (as defined in Rule 101(c)(1) of SEC Regulation M). The Proposal would add exceptions from the lock-up restriction where other protections or market forces obviate the need for the restriction. Due to the existing public market for the securities, the Proposal included a proposed exception from the lock-up restriction for securities acquired from an issuer that meets the registration requirements of SEC Registration Forms S-3, F-3 or F-10.<sup>16</sup> The justification for this proposed exception also applies to securities that are "actively-traded" as defined in Rule 101(c)(1) of SEC Regulation M (*i.e.*, securities that have an average daily trading volume value of at least \$1 million and are issued by an issuer whose common equity securities have a public float value of at least \$150 million; provided, however, that such securities are not issued by the distribution participant or an affiliate of the

---

<sup>16</sup> See proposed Rule 5110(e)(2)(A)(iii).

distribution participant). Accordingly, as discussed in Partial Amendment No. 1, FINRA is proposing to add Rule 5110(e)(2)(A)(ix) to provide that the lock-up restriction will not apply “to a security that is ‘actively-traded’ (as defined in Rule 101(c)(1) of SEC Regulation M).”

SIFMA stated that while the additional exceptions in the Proposal may mitigate the impact of the lock-up restriction to follow-on offerings, a bifurcated approach to IPOs and follow-on offerings is more reflective of market realities and the lock-up for participating members in follow-on offerings should be the same as the lock-up period imposed on insiders in the offering. FINRA previously considered the lock-up period in responding to comments received to the Notice 17-15 Proposal. Commenters to the Notice 17-15 Proposal had conflicting views about the appropriate lock-up period. In particular, NASAA supported requiring a longer lock-up period under Rule 5110 to more closely align the interests of the underwriters with those of the investors in the offering.

The Proposal continues the historical approach of a 180-day lock-up period for both initial and follow-on public offerings. However, an exception from the lock-up restriction may be available for the follow-on public offering, such as the proposed exceptions for securities acquired from an issuer that meets the registration requirements of SEC Registration Forms S-3, F-3 or F-10 and securities that are “actively-traded” as defined in Rule 101(c)(1) of SEC Regulation M.

The consistent 180-day lock-up period for underwriters ensures that they do not accept less investment risk than insiders subject to a 180-day lock-up period. A consistent lock-up period for all public offerings also minimizes the burdens and costs associated with participating members tracking and complying with lock-up periods that differ from public offering to public offering.

In response to the Notice 17-15 Proposal, SIFMA suggested that the exception in proposed Rule 5110(e)(2)(A)(vii) be modified to allow for the sale or other disposition of the securities by registered investment advisers, even if such advisers are affiliated with a participating FINRA member. SIFMA noted that the Proposal did not include the suggested modification but expressed hope that FINRA would be willing to consider requests for relief in appropriate circumstances. FINRA would consider any request for exemptive relief under Rule 5110 pursuant to Rule 5110(i). Rule 5110(i) provides FINRA with exemptive authority for good cause shown after taking into consideration all relevant factors to the extent that such exemption is consistent with the purposes of the Rule, the protection of investors, and the public interest.

#### Non-Cash Compensation

The Proposal did not include any changes to the Rule’s current non-cash compensation provisions as these provisions are the subject of a separate consolidated

approach to non-cash compensation.<sup>17</sup> ABA and SIFMA understood that the Proposal did not include any substantive changes to the non-cash compensation provisions but nevertheless requested clarification that the restrictions on receipt of 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 or the Proposal that implicitly permit the receipt by participating members of non-cash compensation under appropriate circumstances. Rather than including this clarification in the text of the proposed rule, commenters suggested that FINRA provide the clarification in FAQs or in the release or Regulatory Notice accompanying the adoption of the Proposal.

As previously explained in the Proposal, because the non-cash compensation provisions are the subject of a separate consolidated approach to non-cash compensation, the Proposal would incorporate the Rule's current non-cash compensation provisions without modification. In response to the commenters' request for clarification, FINRA confirms that the restrictions on receipt of non-cash compensation set forth in current Rule 5110 and the Proposal are not intended to limit or otherwise be inconsistent with other provisions in current Rule 5110 or the Proposal that implicitly permit the receipt by participating members of non-cash compensation under appropriate circumstances.

#### Prohibited Terms and Arrangements

Rule 5110 includes a list of prohibited unreasonable terms and arrangements in connection with a public offering of securities. The Proposal would clarify and amend the list.

ABA applauded FINRA for adding a provision in proposed Rule 5110(g)(4) that allows the payment prior to the commencement of sales of a public offering of "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." ABA suggested these payments should 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. Receipt of advisory or consulting fees for services provided in connection with a public offering that is not completed has been historically problematic in practice. As such, 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. Participating members may receive termination fees or a ROFR related to an offering that is not completed consistent with Rule 5110(g)(5).

---

<sup>17</sup> See Regulatory Notice 16-29 (August 2016).

ABA suggested that proposed 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.

FINRA believes that reasonable due diligence by a participating member would generally detect whether an issuer’s hiring of 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 Exchange Act Rule 3a4-1 and applicable state law. FINRA 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

Rule 5110 includes two categories of exempt public offerings—offerings that are exempt from filing, but remain subject to the substantive provisions of Rule 5110, and offerings that are exempt from both the filing requirements and substantive provisions of Rule 5110. The Proposal would expand and clarify the scope of the exemptions, which is expected to reduce members’ filing and compliance costs.

Rothwell supported proposed Rule 5110(h)(1)(E)(i) exempting from the filing requirements exchange offers meeting specific requirements. Rothwell also supported the proposed exemptions from both the filing requirements and substantive provisions of Rule 5110 for public offerings of closed-end “tender offer” funds (*i.e.*, closed-end funds that repurchase shares from shareholders pursuant to tender offers), insurance contracts and unit investment trusts.<sup>18</sup> CAI supported the proposed exemption for “any insurance contracts not otherwise included”<sup>19</sup> and stated that the exemption would resolve questions from members about the status of insurance contracts under FINRA rules.

With respect to the exemption in Rule 5110(h)(2)(G) for third-party tender offers, ABA suggested revising this exemption to also include tender offers by issuers for their own securities under the Exchange Act. ABA stated that there is little logic for excluding third-party tender offers, but not issuer self-tenders, when a FINRA member may act as dealer manager in connection with either type of transaction. As

---

<sup>18</sup> See proposed Rule 5110(h)(2)(E), (K) and (L).

<sup>19</sup> See proposed Rule 5110(h)(2)(E).

discussed in the Partial Amendment No. 1, FINRA is proposing to amend Rule 5110(h)(2)(G) to apply to “tender offers made pursuant to SEC Regulation 14D or Rule 13a-4 under the Exchange Act.” Both third-party tender offers and issuer self-tender offers are subject to disclosure, filing and procedural requirements as set forth in the Exchange Act. Moreover, issuer self-tender offers have historically not been filed with FINRA for review pursuant to Rule 5110.

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

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

ABA suggested that the investment grade debt exemption in Rule 5110(h)(1)(A) be further clarified to indicate that the reference to “corporate issuers” is not meant to exclude issuers from reliance on the exemption if they are not organized in “corporate” form, such as limited partnerships or limited liability companies. FINRA previously considered this issue in responding to comments received to the Notice 17-15 Proposal. As previously explained in the Proposal, the approach, which is consistent with current Rule 5110, covers a broad range of legal entities that have qualifying debt securities and has not been problematic in practice. FINRA would interpret “corporate issuers” to include, among other entities, limited partnerships and limited liability companies.

#### Defined Terms

In addition to consolidating the defined terms in one location at the end of the Rule, the Proposal would simplify and clarify Rule 5110’s defined terms. The

Proposal would make the terminology more consistent throughout the Rule's various provisions.

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

As discussed in the Partial Amendment No. 1, FINRA is proposing to amend the proposed definition of bank in Rule 5110(j)(2) to mean "a bank as defined in Section 3(a)(6) of the Exchange Act, a branch or agency in the United States of a foreign bank that is supervised and examined by a federal or state banking authority and otherwise meets the requirements of Section 3(a)(6) of the Exchange Act, or [is] a foreign bank that has been granted an exemption under this Rule and shall refer only to the regulated entity, not its subsidiaries or other affiliates." As the ABA noted, this approach is consistent with the SEC's interpretation of what is a bank for other purposes under the federal securities laws. For example, the SEC provided that for purposes of Rule 15a-6 under the Exchange Act, a foreign bank is excluded from the defined term "bank" except to the extent that the "foreign bank establishes a branch or agency in the United States that is supervised and examined by a federal or state banking authority and otherwise meets the requirements of section 3(a)(6)."<sup>20</sup>

Rothwell requested revising the proposed defined term "experienced issuer" in Rule 5110(j)(6) to explain what requirements must be met to satisfy the "reporting history" requirement. 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.<sup>21</sup>

Commenters expressed concerns that the proposed defined term "experienced issuer" would eliminate the SEC and FINRA history and interpretive guidance that accompany the Form S-3, F-3 and F-10 eligibility requirements.<sup>22</sup> SIFMA suggested

---

<sup>20</sup> See Securities Exchange Act Release No. 27017 (July 11, 1989), 54 FR 30013 (July 18, 1989) (File No. S7-11-88, Registration Requirements for Foreign Broker-Dealers, note 16) and Frequently Asked Questions Regarding Rule 15a-6 and Foreign Broker-Dealers, footnote 3, (March 21, 2013) available at <https://www.sec.gov/divisions/marketreg/faq-15a-6-foreign-bd.htm>.

<sup>21</sup> See, e.g., the eligibility provisions of Forms S-3, F-3 and F-10.

<sup>22</sup> See ABA, Davis Polk and SIFMA.

that the defined term “experienced issuer” would lead to confusion and suggested an alternative definition.<sup>23</sup> If the foregoing definitional changes are not made, SIFMA urged FINRA to allow participating members to continue to rely, as a “safe harbor” alternative to the proposed new formulation, on the existing “pre-1992 standards” set forth in the current Rule.

As discussed in greater detail in the Proposal, rather than referring to the pre-1992 standards for Forms S-3 and F-3 and standards approved in 1991 for Form F-10, the proposed definition of experienced issuer codifies those standards currently in Rule 5110 to simplify the analysis for the benefit of members. FINRA considers any guidance and interpretation issued by the SEC or FINRA to accompany the pre-1992 standards for Forms S-3 and F-3 and standards approved in 1991 for Form F-10 to be valid and illustrative for purposes of interpreting the defined term “experienced issuer.”

Rothwell requests expanding the defined term “independent financial adviser” in Rule 5110(j)(9) and revising proposed Rule 5110(j)(16) to allow an independent financial adviser to provide ordinary services to an issuer and assist the issuer in preparing the offering document and other documents. Application of the Rule to financial advisers was addressed when the defined term “independent financial adviser” was added to Rule 5110 in 2014.<sup>24</sup> The carve out for advisory or consulting services provided to the issuer by an independent financial adviser was provided to remove a possible obstacle to the ability of issuers to obtain advisory or consulting services from members not participating in the offering. With the carve out, issuers are free to seek the benefit of consulting services or advice from a member that is not engaged in the distribution or sale of its securities regarding such matters as the options for financing that may be available to the issuer, the benefits and disadvantages of a public offering and the terms proposed by the underwriters.

---

<sup>23</sup> SIFMA proposed modifying the defined term to mean “an issuer that (i) meets the registrant requirements specified in paragraph I.A of SEC Form S-3, except that for purposes of paragraph I.A.3 thereof, the reference to ‘twelve calendar months’ shall be deemed to refer instead to ‘36 calendar months’ and (ii) has an aggregate market value of outstanding voting and non-voting common equity held by non-affiliates (as calculated pursuant to General Instruction I.B.1 of Form S-3) of (a) at least US\$150 million or (b) at least US\$100 million and the issuer has had an annual trading volume of its common equity of at least three million shares (or share equivalent).”

<sup>24</sup> See Securities Exchange Act Release No. 71372 (January 23, 2014), 79 FR 4793 (January 29, 2014) (Notice of Filing of File No. SR-FINRA-2014-003). See also Letter from Kathryn M. Moore, Associate General Counsel, FINRA, to Kevin O’Neill, Deputy Secretary, SEC, dated April 16, 2014 (regarding File No. SR-FINRA-2014-003).

Rothwell's proposed change 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 does not agree with the proposed expansion of services that may be provided by the independent financial adviser. In 2014, FINRA 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. The scope of services that may be provided by an independent financial adviser under the Rule remains appropriate.

Rothwell suggested amending the proposed defined term "participate" in Rule 5110(j)(16) 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." While the suggested list 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.

ABA and Davis Polk suggested that the proposed definition of "participate" in Rule 5110(j)(16) exclude acting as a broker for a selling shareholder in return for compensation consisting of customary brokerage commissions and under circumstances in which the broker offers and sells the securities as agent on behalf of the selling shareholder without the use of "special selling efforts and selling methods" (as the term is understood for purposes of SEC Regulation M). Commenters stated that the negotiation and execution of a customary brokerage or sale agreement with respect to such activity should not be deemed to constitute "special selling efforts and selling methods" and the participation of a FINRA member in the preparation of an agreement should not be deemed to constitute "involvement in the preparation of the offering document or other documents." Commenters suggested that "involvement in the preparation of the offering document or other documents" should be modified to refer to the "preparation of the offering document or similar disclosure documents used to offer the securities for sale to the public."

Commenters have suggested excluding from the defined term "participate" a broad range of activities, including activities that may render a person an underwriter under the federal securities laws. FINRA does not agree with the broad exclusion but notes that a participating members' compensation for some activities may not be deemed underwriting compensation pursuant to Rule 5110. For example, proposed Supplementary Material .01(b)(5) provides that compensation for providing brokerage, trust and insurance services to the issuer that is received in the ordinary course of business would not be deemed underwriting compensation for purposes of Rule 5110. The negotiation and execution of a customary brokerage or sales agreement for brokerage services for the issuer in the ordinary course would generally fall within the scope Supplementary Material .01(b)(5) and, accordingly, compensation for these activities would not be deemed underwriting compensation

pursuant to Rule 5110. Furthermore, as defined in proposed Rule 5110(j)(12), the “issuer” includes any selling security holder offering securities to the public.

Rothwell requested clarification on the extent of the “issuer” carve out from the defined term “participating member.” In the Proposal, FINRA revised the “participating member” definition in proposed Rule 5110(j)(15) to provide “but does not include the issuer.” This revision was intended to make clear that the “issuer” as defined in proposed Rule 5110(j)(12) is entirely excluded from the proposed “participating member” definition.

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

ABA suggested that the defined term “public offering” should expressly exclude securities offered or sold by a broker-dealer pursuant to Sections 4(a)(3) and 4(a)(4) of the Securities Act.<sup>25</sup> ABA did not provide detail regarding the operation of offerings pursuant to Sections 4(a)(3) and 4(a)(4) of the Securities Act, including whether members currently view these offerings as being subject to Rule 5110 or another rule in the Rule 5100 Series. Moreover, members have not previously filed these offerings with FINRA for review under Rule 5110 or another rule in the Rule 5100 Series and, consequently, FINRA has not been provided information regarding the operation of these offerings. FINRA declines to make the suggested revision.

Commenters asserted that participating members’ purchases of securities in the public offering at the public offering should not be considered underwriting

---

<sup>25</sup> The ABA also suggested a technical change to update the reference in proposed Rule 5110(j)(18)(A) to offerings pursuant to Section 4(a)(6) of the Securities Act to Section 4(a)(5) of the Securities Act. As discussed in the Partial Amendment No. 1, FINRA is proposing to revise the public offering definition’s reference to these offerings as suggested by the commenter.

compensation subject to Rule 5110.<sup>26</sup> FINRA would interpret the Proposal not to include as underwriting compensation non-convertible securities purchased by the participating member in a public offering at the public offering price during the review period. As discussed in the Partial Amendment No. 1, FINRA is proposing to revise the Supplementary Material to expressly exclude securities purchased on these terms from being deemed underwriting compensation under the Proposal.<sup>27</sup> FINRA has seen acquisitions of convertible securities by a participating member with negotiated or preferential terms prohibited under proposed Rule 5110(g)(8). FINRA would consider these securities to be underwriting compensation.

ABA and SIFMA suggested 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. Proposed Supplementary Material .04 takes into account the price at which the securities were acquired. Specifically, under 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. Furthermore, as discussed above, FINRA would interpret the proposed Rule not to include as underwriting compensation non-convertible securities purchased by the participating member in a public offering at the public offering price during the review.

SIFMA requested confirmation that compensation, such as advisory fees, rights of first refusal and securities, 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 as underwriting compensation and is not otherwise subject to the disclosure and other requirements of the Rule or the Proposal. SIFMA stated that

---

<sup>26</sup> See ABA, Davis Polk, Rothwell and SIFMA. Commenters noted questions raised by the inclusion as underwriting compensation of any equity securities acquired by a participating member during the review period under Supplementary Material .01(a)(7) and the scope of the defined term "review period" in proposed Rule 5110(j)(20).

<sup>27</sup> Specifically, FINRA is proposing to amend proposed Supplementary Material .01(a)(7) to provide that underwriting compensation includes "common or preferred stock, options, warrants, and other equity securities, including debt securities convertible to or exchangeable for equity securities, beneficially owned, as defined in Rule 5121 by the participating members the value of which is determined pursuant to this Rule, and acquired during the review period, as defined in this Rule, except that non-convertible securities purchased by a participating member in a public offering at the public offering price during the review period shall not be deemed underwriting compensation;".

such underwriter is not within the definition of “participating member” and, therefore, its compensation should not be covered by the Rule. 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 underwriting compensation for purposes of Rule 5110 and is not subject to the requirements of Rule 5110.

Davis Polk requested confirmation that fees and other compensation paid by an issuer to a foreign broker-dealer affiliated with a participating member in connection with the foreign distribution of an offering occurring both in the U.S. and outside the U.S. simultaneously should not be deemed underwriting compensation under Rule 5110. Affiliates of a participating FINRA member are covered by the “participating member” definition in proposed Rule 5110(j)(15). For a global offering, FINRA commonly sees a collective underwriting compensation amount for the U.S. and non-U.S. portions of the offering. If the participating members are able to divide underwriting compensation so as to separately allocate the underwriting compensation received by the non-U.S. broker-dealer for the non-U.S. portion of the global offering, FINRA would consider that separately allocated underwriting compensation to be outside the scope of Rule 5110 and not subject to the requirements of Rule 5110.

ABA suggested that the inclusion of “finder’s fees, underwriter’s counsel fees, and securities” in the proposed “underwriting compensation” definition in Rule 5110(j)(22) is confusing and unnecessary in light of the much clearer and more fulsome language contained in the Supplementary Material. The Proposal would consolidate the various provisions of the current Rule that address what constitutes underwriting compensation into a single, new definition of “underwriting compensation.” The proposed non-exhaustive lists in Supplementary Material .01 provide examples of payments or benefits that would be and would not be considered underwriting compensation. The non-exhaustive examples do not obviate the need for the defined term to capture the full scope of possible underwriting compensation.

#### Underwriting Compensation

The Proposal would continue to provide two non-exhaustive lists of examples of payments or benefits that would be and would not be considered underwriting compensation.<sup>28</sup> Although the Rule would no longer incorporate the concept of “items of value” (*i.e.*, the non-exhaustive list of payments and benefits that would be included in the underwriting compensation calculation), the proposed non-exhaustive lists are derived from the examples of payments or benefits that currently are considered and not considered items of value. The proposed examples of payments or

---

<sup>28</sup> See proposed Supplementary Material .01 to Rule 5110.

benefits that would not be underwriting compensation include several new examples to provide greater clarity and to address questions raised by members.

Rothwell supported the changes in proposed Supplementary Material .01 of items that would or would not be underwriting compensation. ABA suggested revising proposed Supplementary Material .01(a)(9) to eliminate the one percent valuation assigned to ROFRs. ABA stated that the valuation was added in order to ensure that ROFRs were considered “items of value” under the Rule, but this historical rationale is no longer applicable. FINRA previously considered this issue in responding to comments received to the Notice 17-15 Proposal. As previously explained in the Proposal, ROFRs have historically been assigned a one percent valuation for purposes of Rule 5110. FINRA continues to believe 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.

With respect to proposed Supplementary Material .01(a)(14), ABA does not agree that nominal gifts and occasional entertainment should be considered underwriting compensation subject to the Rule, including the disclosure requirements. Rule 5110 currently applies to the receipt of non-cash compensation. Consistent with FINRA’s proposal to retain the current approach to disclosing underwriting compensation, the proposed rule change would not alter the current requirements for disclosing non-cash compensation. Given Rule 5110’s restrictions on the receipt of non-cash compensation, FINRA would expect non-cash compensation to be nominal in practice. However, consistent with the current Rule, disclosure of non-cash compensation is needed for FINRA to have a complete understanding of underwriting compensation.

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,” ABA suggested deleting the words “to the issuer” in proposed Supplementary Material .01(b)(4)-(6). Davis Polk requested that proposed Supplementary Material .01(b)(5)-(6) be revised to exclude fees for services performed by participating members in the ordinary course of business unrelated to the distribution of the offering. The examples in proposed Supplementary Material .01(b)(4)-(6) of payments or benefits received for services that may be fairly considered unrelated to the public offering were added at the request of members for clarification. FINRA believes that the proposed scope of the examples is appropriate.

ABA and Davis Polk suggested revising proposed Supplementary Material .01(b)(14) to add to this exclusion securities acquired as the result of an “exercise” (in addition to “conversion”) of securities that were originally acquired prior to the review period. Securities acquired as the result of an exercise are covered by proposed Supplementary Material .01(b)(15). Pursuant to proposed Supplementary Material .01(b)(15), securities acquired as the result of an exercise of options or

warrants that were originally acquired prior to the review period would not be underwriting compensation.

As set forth in the Proposal, proposed Supplementary Material .01(b)(12) would provide that compensation received through any stock bonus, pension, or profit-sharing plan that qualifies under Section 401 of the Internal Revenue Code or a similar plan is not underwriting compensation. ABA recommended revising the provision to expressly include securities received under a written compensatory benefit plan in an offering exempt from registration pursuant to Rule 701 under the Securities Act and any other “employee benefit plan” (as such term is defined in Securities Act Rule 405). Davis Polk requested confirmation that grants of equity compensation to immediate family of participating members, other than new employees of the issuer, in the ordinary course of business pursuant to bona fide equity compensation arrangements will not be deemed underwriting compensation.<sup>29</sup>

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

Rothwell requested clarification of what is a similar plan for purposes of proposed Supplementary Material .01(b)(12) and suggested revising the provision to include another form of compensatory plan that is provided to an issuer’s directors or employees as a group, if the plan provides comparable grants of securities to all covered persons in the group and was established in the ordinary course of business. As discussed in the Proposal, FINRA would interpret the reference to a “similar plan” in proposed Supplementary Material .01(b)(12) to include a written compensatory benefit plan for directors and employees that provides comparable grants of securities to similarly situated persons (e.g., a written compensatory benefit plan that provides comparable grants of securities to all qualifying employees). A “similar plan” would

---

<sup>29</sup> Davis Polk also disagreed with the ABA that the exclusion from underwriting compensation only apply to equity grants made pursuant to Rule 701 under the Securities Act due to limitations on annual grants of equity compensation under Rule 701 that force reliance on Section 4(a)(2) of the Securities Act. However, it is not clear that the ABA intended to propose the exclusion as suggested by Davis Polk.

not include a compensatory benefit plan that was developed or structured to circumvent the requirements of Rule 5110.

ABA and Davis Polk suggested revising proposed Supplementary Material .01(b)(21) to expressly reference “bona fide market making activity.” Acting as a bona fide market maker is distinguishable from acting as the underwriter in a public offering. Securities acquired by a member firm acting as a bona fide market maker would not constitute underwriting compensation under Rule 5110 because as a bona fide market maker the member is not acting as an underwriter.

Rothwell supported the principles-based approach in proposed Supplementary Material .02 and .03. Rothwell requested that proposed Supplementary Material .01(b) be amended to include an exclusion for securities and other compensation received in a member offering. SIFMA suggested amending Supplementary Material .01(b) to provide a carve out from underwriting compensation for 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. SIFMA noted that exemptive relief may be available, but routine waiver requests can be avoided by providing that compensation paid to associated persons of a FINRA member or employees of affiliates of the FINRA member (or immediate family members thereof) in the ordinary course under existing employment arrangements would not be considered underwriting compensation.

Where a participating member is offering its securities, FINRA generally would not consider ordinary course payments under existing employment arrangements to be underwriting compensation. While rare, FINRA has seen potential violations of Rule 5110 in offerings of a participating member’s own securities. As such, FINRA continues to have an interest in reviewing securities and other compensation receiving in these offerings and declines to provide a broad exclusion from underwriting compensation.

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

Given that the required participation by a qualified independent underwriter (“QIU”) under Rule 5121 would trigger the filing requirements of Rule 5110, SIFMA requested clarifying guidance on the circumstances in which QIU participation is required. SIFMA stated that Rule 5121’s requirement for QIU participation if the “member(s) primarily responsible for managing the public offering” has/have a “conflict of interest” as defined in Rule 5121(f)(5) is confusing. Absent the availability of another exception, SIFMA suggested that the participation of a QIU should be required only if all of the lead underwriters or managing bookrunners have a conflict of interest and urges FINRA to issue guidance to such effect.

FINRA has previously provided guidance regarding QIU participation pursuant to Rule 5121. For example, FINRA has stated that “[i]n cases where two or

Ms. Vanessa Countryman

July 11, 2019

Page 24

more book-running lead managers have equal responsibilities with regard to due diligence, each must be free of conflicts of interest, otherwise the QIU provisions under [Rule 5121] would apply and the offering would be subject to the filing requirements under Rule 5110.”<sup>30</sup> FINRA is willing to consider requests for additional guidance on Rule 5121 separate from the Proposal, which is for the purpose of modernizing, simplifying and clarifying Rule 5110.

ABA shared SIFMA’s comments regarding QIU participation and stated that, if the requirements are preserved, the filing fee for Rule 5110 should be limited to only those securities subject to the particular shelf takedown offering for which QIU participation is required. FINRA has a regulatory interest in evaluating the public offering as a whole, not just the securities for which QIU participation is required. Accordingly, the filing fee is assessed for the filing as a whole.

\* \* \* \* \*

FINRA believes that the foregoing responds to the material issues raised by the commenters to the rule filing. If you have any questions, please contact me at (202) 728-8013, email: [Jeanette.Wingler@finra.org](mailto:Jeanette.Wingler@finra.org). The fax number of the Office of General Counsel is (202) 728-8264.

Best regards,

/s/ Jeanette Wingler

Jeanette Wingler  
Associate General Counsel

---

<sup>30</sup> See Regulatory Notice 09-49 (August 2009).