

Chapman Client Alert

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Current Issues Relevant to Our Clients

FINRA Requests Comment on Rules Impacting Capital Formation and Proposes Amendments to the Corporate Financing Rule

The Financial Industry Regulatory Authority, Inc. (“*FINRA*”) recently released three Regulatory Notices related to its ongoing review of its members’ involvement in the capital formation process. In Regulatory Notice 17-14, FINRA requests comment on the effectiveness and efficiency of its existing rules, operations and administrative processes governing broker-dealer activities related to the capital-raising process and their impact on capital formation. In Regulatory Notice 17-15, FINRA requests comment on proposed amendments to Rule 5110 (Corporate Financing Rule — Underwriting Terms and Arrangements) that are intended to modernize the rule and to simplify and clarify its provisions. Regulatory Notice 17-16 clarifies the application of FINRA’s research rules to desk commentary by sales and trading and principal trading personnel and solicits comments on a proposal to create a limited safe harbor for eligible desk commentary that may rise to the level of a research report. The Regulatory Notices are available [here](#), [here](#) and [here](#), respectively. Regulatory Notices 17-14 and 17-15 are described in more detail below. Regulatory Notice 17-16 is described in a separate Client Alert, available [here](#).

Request for Comment on Existing Capital Formation Rules

In Regulatory Notice 17-14, FINRA stated its interest in determining whether changes to the FINRA rules, operations or administrative processes related to capital formation would further enhance the capital-raising process while ensuring investor protections. Accordingly, FINRA is requesting comment on the functioning of its rules that most directly apply to the capital-raising process and their effect on capital formation. While the Notice invites comments on all existing rules, it highlights several that FINRA is particularly interested in receiving feedback on:

- Capital Acquisition Broker (“*CAB*”) rules
- Funding Portal rules
- Rule 2241 (Research Analysts and Research Reports)
- Rule 2242 (Debt Research Analysts and Debt Research Reports)
- Rule 2310 (Direct Participation Programs)
- Rule 5100 series governing underwriting and related compensation received by FINRA members in securities offerings

- Rule 5250 (Payments for Market Making)
- Rule 6432 (Compliance with the Information Requirements of Exchange Act Rule 15c2-11)
- Trading Activity Fee rules

Those interested in commenting are encouraged to provide empirical data or other factual support whenever possible. While commenters are invited to provide a wide range of feedback to FINRA, Regulatory Notice 17-14 lists several questions for commenters to consider, including:

- Have FINRA’s rules covering the capital-raising process effectively responded to the problem(s) they were intended to address?
- What, if any, unintended consequences have arisen from FINRA’s rules related to the capital-raising process? How have firms limited or amended their business models and practices in ways unintended by FINRA with a consequence to capital formation or investor protection in order to comply with FINRA’s rules in these areas?
- As currently designed, are the eligibility requirements for the *CAB* rules over- or under-inclusive in any respect? What changes, if any, to these requirements should be considered? Are the requirements applicable to *CABs* appropriately tailored to their business activities? Should any changes to these requirements be considered?

- As currently designed, do FINRA's funding portal rules appropriately address the requirements and objectives of the Jumpstart Our Business Startups Act and the Securities and Exchange Commission's (the "SEC") Regulation Crowdfunding? What changes, if any, should be made to FINRA's rules, and why?

Proposed Amendments to the Corporate Financing Rule

FINRA Rule 5110 prohibits unfair underwriting arrangements in connection with the public offering of securities. The corporate financing rule requires, among other things, that a member that participates in a public offering file information with FINRA about the underwriting terms and arrangements. FINRA reviews this information prior to the commencement of an offering to determine whether the underwriting compensation and other terms and arrangements meet the requirements of the applicable FINRA rules. FINRA is now requesting comment on proposed amendments intended to modernize the corporate financing rule in numerous substantive areas, including filing requirements, filing exemptions, disclosure requirements, underwriting compensation, lock-up restrictions, valuation of securities and prohibited terms and arrangements. The following summarizes several of the important changes the proposed amendments would make to the existing rules.

Filing Requirements

The proposed amendments would extend the deadline for firms to make required filings under Rule 5110 with FINRA from one business day after filing with the SEC to three business days. The proposed amendments would also replace the non-exhaustive list of types of public offerings that are required to be filed with FINRA with the general requirement that all public offerings in which a member participates must be filed unless an exemption applies.

Filing Exemptions

The proposed amendments would add follow-on offerings of closed-end "tender offer" funds that routinely make self-tender offers to the list of offerings that are exempt from filing. Compensation related to the distribution of tender offer fund securities would become subject to the limitations set forth in FINRA Rule 2341 (Investment Company Securities). In addition, the proposal would expand the list of offerings that are exempt from both the filing requirements and substantive regulation of underwriting terms and arrangements to include public offerings of insurance contracts and unit investment trusts. The proposed amendments would also clarify FINRA's existing position that offerings under Regulation S and Rule 144A under the Securities Act of 1933 are not subject to Rule 5110.

Disclosure Requirements

The proposed rule would permit firms to disclose in the prospectus the maximum aggregate amount of all underwriting compensation, rather than the dollar amount of each item of compensation as required under existing Rule 5110. The proposed amendments would also make several clarifying changes to the Rule 5110's Supplementary Material, including issues related to rights of first refusal, securities acquired by participating members, and aggregation of underwriting compensation with other offering expenses.

Underwriting Compensation

The proposed rule would consolidate the various provisions of existing Rule 5110 that address what constitutes underwriting compensation under a single definition. Under the proposed rule, FINRA would evaluate underwriting compensation received during a "review period," the length of which would vary depending on the type of offering. The proposal would amend the rule's Supplementary Material to provide additional examples of payments that would or would not be considered underwriting compensation. The proposed rule would also broaden the availability of several of the exceptions to underwriting compensation by easing or eliminating certain limitations.

Lock-Up Restrictions

The proposed amendments would change the start date of the 180-day lock up restriction on securities that are considered underwriting compensation from the date the prospectus is effective to the date of commencement of sales. The proposal would also add exceptions to the lock-up restrictions for securities of an issuer that meets the registration requirements of SEC Registration Forms S-3, F-3 or F-10 (due to the existence of a public market for securities of the issuer) and for securities that are subject to an underwriting compensation exemption or that do not meet the definition of underwriting compensation. In addition, the proposed rule would also add exceptions to the prohibition for certain transfers of securities to a member's registered persons or affiliates or back to the issuer.

Valuation of Securities

Existing Supplementary Material to Rule 5110 prescribes specific calculations for valuing certain securities received as compensation. The rule proposal would ease the burden on members by allowing for options, warrants and other convertible securities to be valued using methods that are commercially available and appropriate for the type of securities to be valued (i.e., the Black-Scholes model for options).

Prohibited Terms and Arrangements

The proposed amendments would make several clarifying changes to the list of prohibited terms and arrangements and eliminate the prohibition of non-accountable expense reimbursements in excess of three percent of the offering proceeds (which would eliminate the necessity to monitor such expense reimbursements separately).

Request for Comment

FINRA has requested comment on all aspects of the rule proposal, and like Regulatory Notice 17-14, FINRA encourages commenters to provide empirical data or other factual support whenever possible.

What's Next?

Comments responsive to either of the Regulatory Notices discussed above must be received by FINRA by May 30, 2017. Comments may be submitted by emailing pubcom@finra.org or by mailing a hard copy to the address specified in the respective Regulatory Notice.

For More Information

If you would like to discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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