

Corporate Financing

FINRA Amends the FINRA Corporate Financing Rule

Implementation Date for Amended Rule 5110(a)(3)(A), (a)(4)(A)(ii) and (a)(4)(A)(iii): March 20, 2020; Implementation Date of All Other Requirements: September 16, 2020.

Summary

FINRA has amended its Rule 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements) to make substantive, organizational and terminology changes to the rule.¹ The amendments to Rule 5110 modernize, simplify and clarify its provisions while maintaining important protections for market participants, including issuers and investors participating in public offerings. The implementation date for amended Rule 5110(a)(3)(A), (a)(4)(A)(ii) and (a)(4)(A)(iii) is March 20, 2020. The implementation date for all other provisions in amended Rule 5110 is September 16, 2020.

The amended rule text is available in [Attachment A](#).²

Questions regarding this *Notice* should be directed to:

- ▶ Joseph Price, Senior Vice President and Counsel, Office of Regulatory Analysis, at (240) 386-4623 or joseph.price@finra.org;
- ▶ Kathryn M. Moore, Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8200 or kathryn.moore@finra.org; or
- ▶ Jeanette Wingler, Associate General Counsel, OGC, at (202) 728-8013 or jeanette.wingler@finra.org.

Background & Discussion

The ability of small and large businesses to raise capital efficiently is critical to job creation and economic growth. Since its adoption in 1992, Rule 5110 has played an important role in the capital raising process by prohibiting unfair underwriting terms and arrangements in connection with the public offering of securities. Moreover, Rule 5110 continues to be important to ensuring investor protection and market integrity through effective and efficient regulation that facilitates vibrant capital markets.

March 20, 2020

Notice Type

- ▶ Rule Amendment

Suggested Routing

- ▶ Compliance
- ▶ Corporate Finance
- ▶ Legal
- ▶ Registered Representatives
- ▶ Senior Management
- ▶ Syndicate
- ▶ Underwriting

Key Topics

- ▶ Capital Markets
- ▶ Capital Raising
- ▶ Convertible Securities
- ▶ Distribution of Securities
- ▶ Electronic Filing
- ▶ Initial Public Offerings
- ▶ Investment Banking
- ▶ Public Offerings
- ▶ Underwriting Compensation
- ▶ Venture Capital

Referenced Rules & Notices

- ▶ Exchange Act Rules 3a4-1 and 3b-13(a)(1), (2) and (3)
- ▶ FINRA Rule 2310
- ▶ FINRA Rule 5110
- ▶ FINRA Rule 5121
- ▶ FINRA Rule 5122
- ▶ FINRA Rule 5123
- ▶ FINRA Rule 9217
- ▶ Regulatory Notice 16-29
- ▶ SEC Registration Forms S-3, F-3 and F-10
- ▶ SEC Regulations A, D, M and S-K
- ▶ Securities Act Rules 144A, 405, 415 and 701

Rule 5110 requires a member that participates in a public offering to file documents and information with FINRA about the underwriting terms and arrangements.³ FINRA's Corporate Financing Department reviews this information prior to the commencement of the offering to determine whether the underwriting terms and arrangements meet the requirements of the applicable FINRA rules.⁴

FINRA amended a range of provisions in Rule 5110, including reorganizing and improving the readability of the rule. Specifically, FINRA amended the following provisions:

- ▶ filing requirements;
- ▶ filing requirements for shelf offerings;
- ▶ exemptions from filing and substantive requirements;
- ▶ underwriting compensation;
- ▶ venture capital exceptions;
- ▶ treatment of non-convertible or non-exchangeable debt securities and derivatives;
- ▶ lock-up restrictions;
- ▶ prohibited terms and arrangements; and
- ▶ defined terms.⁵

Filing Requirements

FINRA amended Rule 5110's filing requirements to create a process that is both more flexible and more efficient for members. Members have more time to make the required filing with FINRA (extended from one business day after filing with the Securities and Exchange Commission (SEC) or a state securities commission or similar state regulatory authority to three business days).⁶

Further, amended Rule 5110 clarifies:

- ▶ 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;⁷
- ▶ that a public offering in which a member participates must be filed for review unless exempted by the rule;⁸
- ▶ 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;⁹ and
- ▶ 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.¹⁰

Documents and Information

Rule 5110 requires filing with FINRA documents that impact the underwriting terms and arrangements for the public offering, such as financing terms. The amendment clarifies and reduces the types of documents and information that must be filed by directing members to provide the SEC document identification number, if available,¹¹ and requiring filing:

- ▶ industry-standard master forms of agreement *only* if specifically requested to do so by FINRA;¹²
- ▶ the marked pages of 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;¹³ and
- ▶ an estimate of the maximum value for each item of underwriting compensation.¹⁴

Rule 5110(a)(4)(A)(ii) requires filing an engagement letter with FINRA for review when the engagement letter contains terms relevant to the underwriting terms and arrangements of the public offering being reviewed pursuant to Rule 5110. Filing of engagement letters that do not contain terms relevant to the underwriting terms and arrangements of the public offering being reviewed pursuant to Rule 5110 is not required (*e.g.*, a stand-alone M&A letter whose terms are unrelated to the public offering being reviewed pursuant to Rule 5110 is not required to be filed). However, based on information that comes to the attention of the Corporate Financing Department staff, the staff may question filers about the relevancy (and, therefore, need to file with FINRA) of engagement letters and other documents.

Rule 5110(a)(4)(B)(iii) requires a representation regarding whether any officer or director of the issuer and any beneficial owner of any class of the issuer's equity and equity-linked securities is an associated person or affiliate of a participating member. FINRA raised the threshold beneficial ownership level in Rule 5110 from 5 percent to 10 percent or more of any class of the issuer's equity or equity-linked securities. This change provides greater flexibility to participating members in relation to representing to FINRA beneficial ownership information while still requiring that participating members provide information needed to identify potential conflicts of interest.¹⁵

To reduce costs and administrative burdens on participating members, the amended rule provides that participating members are not required to file a description of any securities acquired in accordance with Supplementary Material .01(b) to Rule 5110, which sets forth a non-exhaustive list of payments that generally are not deemed to be underwriting compensation.¹⁶ However, the rule continues to require a description of any securities of the issuer that are acquired and beneficially owned by any participating member during the review period.¹⁷

Terminated and Revised Public Offerings

Amended Rule 5110 adds a new provision 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.¹⁸ Information regarding underwriting compensation received or to be received in terminated offerings is relevant to FINRA's evaluation of compliance with Rule 5110.

FINRA interprets 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).¹⁹ Furthermore, FINRA considers the information received pursuant to Rule 5110(a)(4)(C) in assessing a participating member's participation in any revised public offering.

Rule 5110 applies to underwriting compensation received in a prior public offering that was terminated 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 offerings. FINRA considers securities and other compensation received as part of the prior terminated offering as underwriting compensation if the member participates in the revised public offering. However, payment for accountable expenses in the prior terminated offering will be excluded from underwriting compensation in the revised public offering.²⁰

Including unaccountable expenses, securities and other compensation received in the prior terminated offering as underwriting compensation in a revised offering is necessary to prevent a member from being compensated twice for performing the same services for the issuer. Underwriting compensation received by a member in a prior terminated offering, however, would not be counted towards the aggregate total compensation for the revised offering if the member does not participate in the revised public offering.

Filing Requirements for Shelf Offerings

Issuers meeting specified reporting history and other requirements are eligible to use shelf registration statements. A shelf-eligible issuer can use a shelf takedown to publicly offer securities on a continuous or delayed basis to meet funding needs or to take advantage of favorable market conditions. Public offerings by some shelf-eligible issuers have historically been exempt from Rule 5110's filing requirement; however, public offerings by other shelf-eligible issuers have historically been subject to Rule 5110's filing requirement. The amendment codifies the historical standards for public offerings that are exempt from the filing requirement and streamlines the filing requirements for shelf offerings that remain subject to the filing requirement.

Shelf Offerings Exempt From the Filing Requirement

A public offering by an “experienced issuer” (*i.e.*, an issuer with a 36-month reporting history and at least \$150 million aggregate market value of voting stock held by non-affiliates or, alternatively, the aggregate market value of voting stock held by non-affiliates is at least \$100 million and the issuer has an annual trading volume of three million shares or more in the stock) are exempt from Rule 5110’s filing requirement.²¹ Unless subject to another exemption, public offerings of issuers that do not meet the reporting history and float requirement as codified in the “experienced issuer” definition have historically been subject to Rule 5110’s filing requirement, including shelf offerings by these issuers.

Shelf Offerings Subject to the Filing Requirement

Shelf offerings by issuers that do not meet the “experienced issuer” definition continue to be subject to Rule 5110’s filing requirement. However, to facilitate the ability of issuers to take advantage of favorable market conditions on short notice and to quickly raise capital through takedown offerings, the amendment streamlines the filing requirements for shelf offerings to require that only the following documents and information must be filed: (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).²²

For these shelf offerings, FINRA will access the base shelf registration statement, amendments and prospectus supplements in the SEC’s Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system and populate the information necessary to conduct a review in the FINRA’s Public Offering System. Upon filing of the required registration statement number pursuant to Rule 5110(a)(4)(E)(i), FINRA will provide the no objections opinion. To further facilitate issuers’ ability to timely access capital markets, FINRA’s review of documents and information related to a shelf takedown offering for compliance with Rule 5110²³ will occur on a post-takedown basis.²⁴

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 amendment reorganizes, expands and clarifies the scope of these exemptions.

Consistent with historical practice in interpreting the exemption available to corporate issuers,²⁵ the amended rule clarifies that securities of banks and foreign banks that have qualifying outstanding debt securities are exempt from the filing requirement.²⁶ FINRA does not intend for the investment grade debt exemption in Rule 5110(h)(1)(A) 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, Rule 5110(h)(1)(A) provides an exemption for “securities offered by a bank, foreign 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” (emphasis added).

The amendment also expands the list of offerings that are exempt from both the filing requirements and substantive provisions of Rule 5110 to include public offerings of closed-end “tender offer” funds (*i.e.*, closed-end funds that repurchase shares from shareholders pursuant to tender offers), insurance contracts, unit investment trusts and issuer self-tender offers.²⁷ In addition, the amendment reclassifies three items from offerings exempt from filing and rule compliance to offerings excluded from the definition of “public offering.” The three items are: (1) offerings exempt from registration with the SEC pursuant to Sections 4(a)(1), (2) and (5) of the Securities Act; (2) offerings exempt from registration under specified SEC Regulation D provisions; and (3) offerings of exempted securities as defined in Section 3(a)(12) of the Securities Exchange Act of 1934 (“Exchange Act”).²⁸ This reclassification is consistent with the treatment of the offerings in FINRA Rule 5121 (Public Offerings of Securities With Conflicts of Interest).²⁹

Underwriting Compensation

Amended Rule 5110 clarifies what is considered “underwriting compensation.” As an initial matter, the amendment consolidates the various provisions of the rule that address what constitutes underwriting compensation into a single, new definition of “underwriting compensation.” Underwriting compensation is defined to mean “any payment, right, interest, or benefit received or to be received by a participating member from any source for underwriting, allocation, distribution, advisory and other investment banking services in connection with a public offering.” Underwriting compensation also includes “finder’s fees, underwriter’s counsel fees and securities.”³⁰

Review Period

To better reflect the different types of offerings subject to Rule 5110, amended Rule 5110 adopts the defined term “review period” and the applicable time period varies based on the type of offering. Specifically, “review period” is defined as follows: (1) for a firm commitment offering, the 180-day period preceding the required filing date through the 60-day period following the effective date of the offering; (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 Securities Act Rule 415, 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.³¹ Accordingly, any payment, right, interest or benefit that meets the definition of “underwriting compensation” received by participating members during the applicable review period will be presumed to be underwriting compensation.

Rule 5110 will continue to require that the aggregate underwriting compensation that participating members receive in connection with a public offering is fair and reasonable.³² In considering whether the aggregate compensation is fair and reasonable, FINRA will continue to take into account the following factors, as well as all other relevant facts and circumstances:

- ▶ the anticipated maximum amount of offering proceeds;
- ▶ whether the offering is being distributed on a firm commitment or best efforts basis; and
- ▶ whether the offering is an initial or follow-on offering.

Examples of What Is and What Is Not Underwriting Compensation

Amended Rule 5110 continues to provide two non-exhaustive lists of examples of payments or benefits that are and are not considered underwriting compensation.³³ Although the amended rule no longer incorporates the concept of “items of value” (*i.e.*, the list of payments and benefits that were included in the underwriting compensation calculation), the non-exhaustive lists in the amended rule are derived from the examples of payments or benefits that were considered and not considered items of value. For example, the Supplementary Material clarifies the prior 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, are considered underwriting compensation.³⁴

The examples of payments or benefits that are not underwriting compensation include several new examples. Payments or benefits are generally not underwriting compensation when received by members for providing services unrelated to the public offering and when the payments or benefits are consistent with those received by other similarly situated persons and customary and appropriate for the services provided. Securities acquired in some transactions identified in the examples (*e.g.*, securities acquired in a dividend paid during the review period or as a result of a conversion of securities originally acquired before the review period) are the result of bona fide financing or investing activities that are unrelated to the public offering under review and the securities acquired were not intended to provide underwriting compensation to a participating member. Examples of securities acquisitions that are intended to provide underwriting compensation to a participating member related to the public offering under review include acquisitions where the terms of the securities were altered to provide additional compensation to the participating member during the review period or where the securities were acquired in a

transaction that was intended primarily to compensate the participating member related to the public offering, such as a transaction where only the participating member is offered the opportunity to invest. FINRA does not believe that these types of securities acquisitions are bona fide financing or investing activities and, consequently, the securities acquisitions would be subject to Rule 5110's requirements.

Amended Rule 5110 includes the following examples of payments or benefits that are not considered underwriting compensation:

- ▶ payments for records management and advisory fees and expenses in connection with the conversion of the issuer from a mutual holding company to a stock holding company;³⁵
- ▶ the payment or reimbursement of legal costs resulting from a contractual breach or misrepresentation by the issuer;³⁶
- ▶ 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);³⁷
- ▶ 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;³⁸
- ▶ securities acquired in the secondary market by a participating member that is a broker-dealer in connection with the performance of bona fide customer facilitation activities and bona fide market making activities if acquired at a fair price (taking into account, among other things customary commissions, mark-downs and other charges);³⁹ and
- ▶ 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 701.⁴⁰

Regarding 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., affiliates of a participating FINRA member are covered by the "participating member" definition in 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 considers that separately allocated underwriting compensation to be outside the scope of Rule 5110 and not subject to the requirements of Rule 5110. In addition, 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.

Principles-Based Approach

To give participating members reasonable flexibility with respect to issuer securities acquired in certain financing transactions, amended Rule 5110 takes a principles-based approach in considering whether issuer securities acquired from third parties or in directed sales programs may be excluded from underwriting compensation. This principles-based approach starts with the presumption that the issuer securities received during the review period are underwriting compensation. However, FINRA will consider the factors set forth in Supplementary Material to Rule 5110 and discussed below in determining whether the securities may be excluded from underwriting compensation.⁴¹ A participating member is responsible for providing sufficient documents and information for FINRA's consideration when applying the factors to a particular securities acquisition.

With respect to issuer securities received from third parties, it is important to note that the definition of "underwriting compensation" includes payments, rights, interests, or benefits received or to be received by a participating member *from any source* for underwriting, allocation, distribution, advisory and other investment banking services in connection with a public offering. However, some acquisitions of issuer securities from third parties for purposes unrelated to the public offering should not be deemed underwriting compensation (*e.g.*, securities acquired in ordinary course transactions executed over a participating member's trading desk during the review period from third parties).

To address these situations, the amended rule adopts a principles-based approach to considering whether securities of the issuer acquired from third parties may be excluded from underwriting compensation. Specifically, under Supplementary Material .03 to Rule 5110, FINRA will consider the following factors, as well as any other relevant factors and circumstances: (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 participating member engages in the transactions as part of its 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 (commonly called friends and family programs), it is important to note that the definition of "participating member" includes any FINRA member that is participating in a public offering, any affiliate or associated person of the member, and any immediate family of an associated person of the member, but does not include the issuer.⁴² However, associated persons and their immediate family members may have relationships with issuers that motivate the issuer to sell shares to these persons in directed sales programs. These acquisitions typically are unrelated to the underwriting services provided by a participating member.

To address these situations, FINRA will take a principles-based approach to considering whether an acquisition of securities by a participating member pursuant to an issuer's directed sales program may be excluded from underwriting compensation. Specifically,

under Supplementary Material .04 to Rule 5110, FINRA will consider the following factors, as well as any other relevant factors and circumstances: (1) the existence of a pre-existing relationship between the issuer and the person acquiring the securities; (2) the nature of the relationship; and (3) 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.

Venture Capital Exceptions

Rule 5110 provides exceptions designed to distinguish securities acquired in bona fide venture capital transactions from those acquired as underwriting compensation (for brevity, referred to herein as the “venture capital exceptions”). Recognizing that bona fide venture capital transactions contribute to capital formation, the amendment modifies, clarifies and expands the exceptions to further facilitate members’ participation in bona fide venture capital transactions. Importantly, 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.

Amended Rule 5110 no longer treats as underwriting compensation securities acquisitions covered by two of the prior exceptions: (1) securities acquisitions and conversions to prevent dilution; and (2) securities purchases based on a prior investment history. Instead, these acquisitions are listed in the examples of payments that are not underwriting compensation because they are based on a prior investment history and are subject to the terms of the original securities that were acquired before the review period.⁴³

Purchases and Loans by Certain Affiliates and Investments in and Loans to Certain Issuers

The amendment broadens two of the 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 percent of the issuer’s total equity securities.⁴⁴ The 25 percent threshold limits each member and its affiliates from acquiring more than 25 percent of the issuer’s total equity securities, which typically establishes a control relationship. The threshold, which was codified in 2004, provided protection from overreaching by members at a time when there was a concern about limiting the aggregate amount of equity acquired in pre-offering transactions. Subsequent regulatory changes in other areas, such as the 2009 revision of Rule 5121 regarding public offerings with a conflict of interest,⁴⁵ have added protections and are more appropriate to address acquisitions that create control relationships.

These venture capital exceptions specify that the affiliate must be primarily in the business of making investments or loans. The amendment expands the scope of these exceptions to include that the affiliate, directly or through a subsidiary it controls, must be in such business and further permits that the entity may be newly formed by such affiliate.⁴⁶

Private Placements With Institutional Investors

Rule 5110(d)(3) addresses private placements with institutional investors. The exception requires that the institutional investors that are not affiliates of participating members must purchase at least 51 percent of the total number of securities sold in the private placement at the same time and on the same terms as those purchased by participating members. In addition, the amendment raises the percentage that participating members in the aggregate may acquire from 20 percent to 40 percent of the securities sold in the private placement.⁴⁷ These private placements typically occur before the syndicate is formed and, therefore, members may not know at the time whether their participation in the private placement would impact the issuer's future public offering by triggering the threshold.

The amendment also expands the scope of Rule 5110(d)(3) to include securities purchased in the private placement with institutional investors or securities acquired as compensation for providing services for a private placement (rather than just acting as the placement agent).⁴⁸

Co-Investments With Certain Regulated Entities

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 securities acquired by the participating member in a private placement are unlikely to be underwriting compensation. To address such co-investments, the amendment adopts 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 registered under the Investment Company Act, not traded on an exchange, and no such entity is an affiliate of a member participating in the offering.

Significantly Delayed Offerings

A public offering may be significantly delayed for reasons beyond the issuer's control (*e.g.*, unfavorable market conditions) and during this delay the issuer may require funding. Furthermore, a member may make bona fide investments in or loans to the issuer during this delay to satisfy the issuer's funding needs and any securities acquired as a result of this funding may be unrelated to the anticipated public offering. FINRA provides some additional flexibility in the availability of the venture capital exceptions for securities acquired where the public offering has been significantly delayed.

The amendment adopts a principles-based approach when a public offering has been significantly delayed and the issuer needs funding. FINRA will consider 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. This principles-based approach starts with the presumption that the venture capital exception is not available where the securities were acquired after the required filing date. However, FINRA will consider the factors in Supplementary Material .02 to Rule 5110 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 will consider the following principles, 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. A participating member is responsible for providing documents and information sufficient for FINRA to consider in applying the principles to a particular securities acquisition.

Timing

FINRA interprets the venture capital exceptions to provide that the determination of whether a securities acquisition qualifies under an exception is to be made at the time of the acquisition.⁴⁹ FINRA considers what the participating member knew, or reasonably should have known, at the time of a securities acquisition in assessing whether the securities acquisition may be excluded from underwriting compensation pursuant to the venture capital exceptions. A securities acquisition must be made prior to the required filing date to qualify for the venture capital exceptions. Accordingly, Rule 5110(d)(1)-(4) retains 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.

Treatment of Non-Convertible or Non-Exchangeable Debt Securities and Derivatives

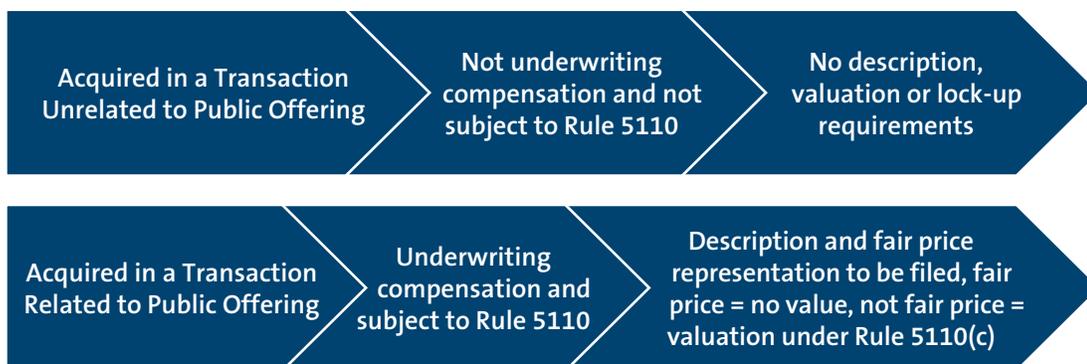
FINRA clarifies the treatment of non-convertible or non-exchangeable debt securities and derivative instruments.⁵⁰ The amended rule expressly provides that non-convertible or non-exchangeable debt securities and derivative instruments acquired in a transaction *unrelated* to a public offering is *not* considered underwriting compensation.⁵¹ Accordingly, the non-convertible or non-exchangeable debt securities and derivative instruments

acquired in a transaction *unrelated* to a public offering is *not* subject to Rule 5110 (i.e., a description of the non-convertible or non-exchangeable debt securities and derivative instruments need not be filed with FINRA,⁵² there are no valuation-related requirements and the lock-up restriction does not apply).

In contrast, non-convertible or non-exchangeable debt securities and derivative instruments acquired in a transaction *related* to a public offering is considered underwriting compensation. For any non-convertible or non-exchangeable debt securities and derivative instruments acquired in a transaction *related* to the public offering, the amendment clarifies 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.⁵³

FINRA also clarifies that the valuation depends upon whether the non-convertible or non-exchangeable debt securities or derivative instruments acquired in a transaction *related* to a public offering were or were not acquired at a fair price. Specifically, the amended rule clarifies that non-convertible or non-exchangeable debt securities and derivative instruments acquired at a *fair price* is considered underwriting compensation but has *no* compensation value. In contrast, the amended rule provides that non-convertible or non-exchangeable debt securities and derivative instruments *not* acquired at a *fair price* is considered underwriting compensation and subject to the *normal valuation requirements* of Rule 5110.

The following charts provide an overview of the treatment of non-convertible or non-exchangeable debt securities and derivative instruments under Rule 5110.⁵⁴



Lock-Up Restrictions

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. During the lock-up period, securities that are underwriting compensation are restricted from sale or transfer and may not be pledged as collateral or made subject to any derivative contract or other transaction that provides the effective economic benefit of sale or other prohibited disposition.⁵⁵ Because a prospectus may become effective long before the commencement of sales, the amended rule provides 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).⁵⁶ The amended rule also provides that the lock-up restriction must be disclosed in the section on distribution arrangements in the prospectus or similar document consistent with Supplementary Material .05 to Rule 5110 requiring disclosure of the material terms of any securities.⁵⁷

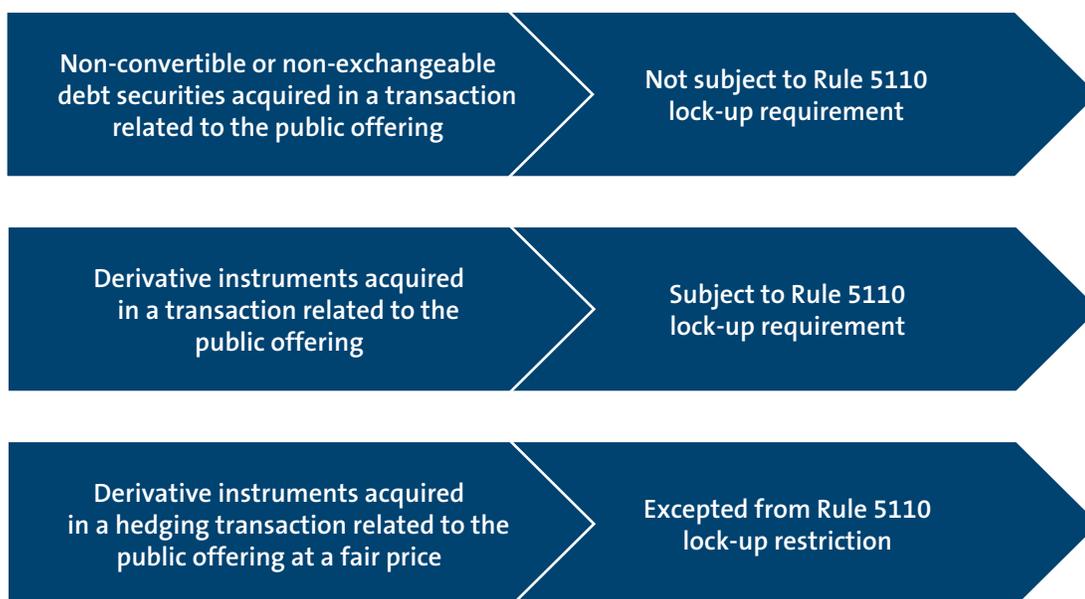
The amended rule adds exceptions from the lock-up restriction for clarity or where other protections or market forces obviate the need for the restriction, including exceptions for:

- ▶ securities acquired from an issuer that meets the registration requirements of SEC Registration Forms S-3, F-3 or F-10;⁵⁸
- ▶ securities acquired in a transaction meeting one of Rule 5110's venture capital exceptions;⁵⁹
- ▶ 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 distribution participant);⁶⁰
- ▶ securities that were received as underwriting compensation and are registered and sold as part of a firm commitment offering;⁶¹ and
- ▶ derivative instruments acquired in connection with a hedging transaction related to the public offering and at a fair price.⁶²

The amended rule also modifies the lock-up restrictions to:

- ▶ permit the transfer or sale of the security back to the issuer in a transaction exempt from registration with the SEC;⁶³
- ▶ permit the transfer of any security to any member participating in the offering and its officers or partners, its registered persons or affiliates if all transferred securities remain subject to the restriction for the remainder of the lock-up period;⁶⁴ and
- ▶ because Supplementary Material .01(b)(20) to Rule 5110 provides that securities acquired subsequent to the issuer's IPO in a transaction exempt from registration under Securities Act Rule 144A is not underwriting compensation, the amendment correspondingly deletes as unnecessary the exception from the lock-up restriction for those securities.

In addition, the amendment provides clarity about the treatment of non-convertible or non-exchangeable debt securities and derivative instruments acquired in transactions related to a public offering.⁶⁵ The following charts provide an overview of the application of Rule 5110's lock-up requirement to non-convertible or non-exchangeable debt securities and derivative instruments.



Prohibited Terms and Arrangements

Amended Rule 5110 clarifies and amends the list of prohibited unreasonable terms and arrangements in connection with a public offering of securities, such as:

- ▶ clarifying that it is considered a prohibited arrangement for any underwriting compensation to be paid prior to the commencement of sales of the 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;⁶⁶
- ▶ simplifying a provision that relates to payments made by an issuer to waive or terminate a ROFR to participate in a future capital-raising transaction;⁶⁷ and

- ▶ referring 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.⁶⁸

Defined Terms

In addition to consolidating the defined terms in one location at the end of the rule, the amendment simplifies and clarifies Rule 5110's defined terms. Most notably, the amendment consolidates the various provisions in the rule that address what constitutes underwriting compensation into a single, new definition of "underwriting compensation."⁶⁹

The amendment eliminates the term "underwriter and related persons" and instead uses the defined term "participating member."⁷⁰ However, the definition of underwriting compensation ensures that the rule continues to address fees and expenses paid to persons previously covered by the term "underwriter and related persons" (*e.g.*, underwriter's counsel fees and expenses, financial consulting and advisory fees, finder's fees). In addition, to clarify the scope of covered persons, the amendment incorporates the definition of "associated person" in Article I, Section (rr) of the FINRA By-Laws and revises the "issuer" definition to refer to the "registrant or other person."⁷¹

Amended Rule 5110 also moves the following defined terms:

- ▶ the definition of "public offering" from Rule 5121 to Rule 5110 and modifies the definition to add "made in whole or in part in the United States" to clarify the jurisdictional scope;⁷² and
- ▶ the definition of "Net Offering Proceeds" from Rule 5110 to Rule 5121 without modification because the term is used only in Rule 5121.⁷³

Furthermore, the amendments harmonizes the definition of bank in the venture capital exceptions and the exemption in Rule 5110(h)(1)⁷⁴ and includes new defined terms to provide greater predictability for members in complying with the Rule (*e.g.*, "equity-linked securities," "overallotment option," "review period").

Amended Rule 5110, rather than referring to the pre-1992 standards for Forms S-3 and F-3 and standards approved in 1991 for Form F-10, codifies those standards in the new defined term "experienced issuer." FINRA considers any guidance and interpretation, including, but not limited to, 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 to be valid and illustrative for purposes of interpreting the defined term "experienced issuer." FINRA emphasizes that the defined term is intended for simplification only, and incorporation of the standards into the defined term do not alter the scope of public offerings subject to Rule 5110.

Disclosure Requirements

The SEC's Regulation S-K requires fees and expenses identified by FINRA as underwriting compensation to be disclosed in the prospectus.⁷⁵ The amended rule continues to require the disclosure requirement to itemize underwriting compensation in the prospectus,⁷⁶ but makes explicit the existing practice of disclosing specified material terms and arrangements related to underwriting compensation in the prospectus. This explicit provision requires a description for: (1) any 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, lock-up periods).⁷⁷

Implementation

The implementation date for amended Rule 5110(a)(3)(A), (a)(4)(A)(ii) and (a)(4)(A)(iii) is March 20, 2020. The implementation date for all other provisions in amended Rule 5110 is September 16, 2020. FINRA's Corporate Financing Department will publish, prior to the September 16, 2020 implementation date, guidance on how the implementation date applies to new and amended filings on [FINRA's website](#).

Additional Resources

Participating members currently have access to summary information concerning their filings through the Public Offering Dashboard. The Dashboard is a tool available to participating members through the Firm Gateway that shows the status of each filing made on behalf of the participating member. Each participating member's Super Account Administrator (SSA) is responsible for granting employee access to the Dashboard. Additional information related to the Dashboard is included in the reference materials in this *Notice*.

FINRA's Corporate Financing Department will publish, prior to the September 16, 2020 implementation date, updated reference materials and other guidance on [FINRA's website](#).

Endnotes

1. See Exchange Act Release No. 87855 (December 23, 2019), 84 FR 72396 (December 31, 2019) (Order Approving File No. SR-FINRA-2019-012).
2. Attachment A includes Rule 5110 as amended by the rule filing. The rule filing also updated cross-references to Rule 5110 and made other non-substantive changes to FINRA Rules 2310 (Direct Participation Programs), 5121 (Public Offerings of Securities With Conflicts of Interest), 5122 (Private Placements of Securities Issued by Members), 5123 (Private Placements of Securities) and 9217 (Violations Appropriate for Disposition Under Plan Pursuant to SEA Rule 19d-1(c)(2)).
3. The following are examples of public offerings that are routinely filed: (1) initial public offerings (IPOs); (2) follow-on offerings; (3) shelf offerings; (4) rights offerings; (5) offerings by direct participation programs (DPPs) as defined in Rule 2310(a)(4); (6) offerings by real estate investment trusts (REITs); (7) offerings by a bank or savings and loan association; (8) exchange offerings; (9) offerings pursuant to SEC Regulation A; and (10) offerings by closed-end funds.
4. FINRA does not approve or disapprove an offering; rather, it issues an opinion based on a review that relates solely to the FINRA rules governing underwriting terms and arrangements and the opinion does not purport to express any determination of compliance with any federal or state laws, or other regulatory or self-regulatory requirements regarding the offering. A member may proceed with a public offering only if FINRA has provided an opinion that it has no objection to the proposed underwriting terms and arrangements. See Rule 5110(a)(1)(C)(ii).
5. The rule change does not include any changes to the valuation of underwriting compensation or non-cash compensation provisions. The non-cash compensation provisions are the subject of a separate consolidated approach to non-cash compensation. See [Regulatory Notice 16-29](#) (August 2016). The restrictions on receipt of non-cash compensation set forth in Rule 5110 are not intended to limit or otherwise be inconsistent with other provisions in Rule 5110 that implicitly permit the receipt by participating members of non-cash compensation under appropriate circumstances.
6. See Rule 5110(a)(3)(A). The documents and information required to be filed under Rule 5110 are filed in the FINRA Public Offering System for review and, if available, the associated SEC document identification number should be provided. See Rule 5110(a)(4).
7. See Rule 5110(a)(3)(B). Participating members are responsible for filing public offerings with FINRA. While an issuer may file an offering with FINRA if a participating member has not yet been engaged, a participating member must assume filing responsibilities once it has been engaged. Issuer filings continue to be permitted for shelf offerings.
8. See Rule 5110(a)(2).
9. See Rule 5110(a)(1)(C).
10. See Rule 5110(a)(1)(B).
11. Depending on the filing type, an SEC document identification number could include a document control number, document file number or accession number. For purposes of clarity, the lack of an SEC document identification number does not obviate the need to submit the documents and information set forth in Rule 5110(a)(4).

12. See Rule 5110(a)(4)(A)(ii). A member may use a master form of agreement which is a standard form used across like offerings and transactions in which the member participates (e.g., a master agreement among underwriters).
13. See Rule 5110(a)(4)(A)(iii). Examples of documents that impact the underwriting terms and arrangements include those that reflect an increase or decrease to the anticipated offering size, method of distribution, and changes to the participating members or the services for which members are engaged.
14. See Rule 5110(a)(4)(B)(ii).
15. Rule 5121 defines “control” as, among other things, beneficial ownership of 10 percent or more of an entity’s common or preferred equity.
16. See Rule 5110(a)(4)(B)(iv).
17. See Rule 5110(a)(4)(B)(iv).
18. See Rule 5110(a)(4)(C) and Rule 5110(g)(5). In 2014, FINRA amended Rule 5110 to expand and specify the circumstances under which underwriting compensation in excess of a reimbursement of out-of-pocket expenses, and termination fees and rights of first refusal (ROFRs), could be received in connection with an offering that was not completed or when a member was terminated from an offering. See Exchange Act Release No. 72114 (May 7, 2014), 79 FR 27355 (May 13, 2014) (Order Approving File No. SR-FINRA-2014-004).
19. Termination fees may include cash, securities, a right of first refusal or any other form of compensation, but do not include payments governed by a separate agreement for services unrelated to a public offering.
20. See Supplementary Material .01(a)(13) to Rule 5110.
21. The rule change deletes references to the pre-1992 standards for Form S-3 and standards approved in 1991 for Form F-10 and instead codifies 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 or alternatively the aggregate market value of voting stock held by non-affiliates is at least \$100 million and the issuer has an annual trading volume of three million shares or more in the stock. See Rule 5110(j)(6).
22. See Rule 5110(a)(4)(E).
23. In addition to compliance with FINRA Rule 5110, FINRA staff will also review for compliance with other applicable rules such as FINRA Rule 2310, FINRA Rule 5121 and other SEA Rules such as 15c2-4 and 10b-9, if applicable.
24. Issuers continue to be permitted to file a base shelf registration statement in anticipation of retaining a member to participate in a takedown offering.
25. The rule’s reference to “corporate issuers” covers a broad range of legal entities that have qualifying debt securities and has not been problematic in practice. FINRA interprets “corporate issuers” to include, among other entities, limited partnerships and limited liability companies.
26. See Rule 5110(h)(1)(A). The exemption has historically been interpreted to apply to qualifying securities offered by a bank; however, the lack of a specific reference to “bank” securities in the rule text raised questions by members.
27. See Rule 5110(h)(2)(E), (G), (K) and (L). Previously Rule 5110 provided an exemption from the substantive and filing requirement for third-party tender offers. The amendment expands the exemption to include issuer self-tender offers.

28. See Rule 5110(j)(18).
29. See Rule 5110(j)(18).
30. See Rule 5110(j)(22).
31. See Rule 5110(j)(20).
32. See Rule 5110(a)(1)(A).
33. See Supplementary Material .01 to Rule 5110.
34. See Supplementary Material .01(a)(2) to Rule 5110. See also Supplementary Material .01(a)(3) and (4) to Rule 5110 which includes fees and expenses of participating members' counsel and finder's fees paid or reimbursed to, or paid on behalf of, the participating members (except for reimbursement of "blue sky" fees) as underwriting compensation.
35. See Supplementary Material .01(b)(3) to Rule 5110.
36. See Supplementary Material .01(b)(4) to Rule 5110.
37. See Supplementary Material .01(b)(22) to Rule 5110.
38. See Supplementary Material .01(a)(7) to Rule 5110.
39. See Supplementary Material .01(b)(21) to Rule 5110.
40. See Supplementary Material .01(b)(12) to Rule 5110. FINRA interprets the reference to a "similar plan" in 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" does not include a compensatory benefit plan that was developed or structured to circumvent the requirements of Rule 5110.
41. See Supplementary Material .03 and .04 to Rule 5110. A principles-based approach is also discussed in this Notice under the section "Venture Capital Exceptions – Significantly Delayed Offerings."
42. See Rule 5110(j)(15).
43. See Supplementary Material .01(b)(14), (16-18) to Rule 5110.
44. See Rule 5110(d)(1) and (2).
45. Rule 5121 requires prominent disclosure of conflicts and, for certain types of conflicts, the participation of a qualified independent underwriter in the preparation of the registration statement.
46. See Rule 5110(d)(1)(D) and (d)(2)(A)(iv).
47. See Rule 5110(d)(3)(C).
48. See Rule 5110(d)(3).
49. See Supplementary Material .07 to Rule 5110.
50. The term "derivative instrument" is defined to mean any eligible OTC derivative instrument as defined in Exchange Act Rule 3b-13(a)(1), (2) and (3). See Supplementary Material .06(b) to Rule 5110.
51. See Supplementary Material .01(b)(19) to Rule 5110.
52. See Rule 5110(a)(4)(B)(iv)b.
53. See Rule 5110(a)(4)(B)(iv)a. The term "fair price" is defined 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 rule change also clarifies 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 service, including underwriting services will not be deemed to be entered into or acquired at a fair price. See Supplementary Material .06(b) to Rule 5110.

54. See Supplementary Material .06(a) to Rule 5110 and Rule 5110(c).
55. Securities acquired by a member that are not considered underwriting compensation are not subject to the lock-up restrictions of Rule 5110.
56. See Rule 5110(e)(1)(A).
57. See Rule 5110(e)(1)(B).
58. See Rule 5110(e)(2)(A)(iii).
59. See Rule 5110(e)(2)(A)(vi). While these securities are not considered underwriting compensation and, thus, not subject to the lock-up restriction, the exception provides additional clarity with respect to these securities.
60. See Rule 5110(e)(2)(A)(ix).
61. See Rule 5110(e)(2)(A)(viii).
62. See Rule 5110(e)(2)(A)(v). Derivative instruments acquired in transactions related to the public offering that do not meet the requirements of the exception continue to be subject to the lock-up restriction.
63. See Rule 5110(e)(2)(B)(iii).
64. See Rule 5110(e)(2)(B)(i). The rule includes an exception to the lock-up for the exercise or conversion of any security, if all such securities received remain subject to the lock-up restriction for the remainder of the 180-day lock-up period. See Rule 5110(e)(2)(B)(ii).
65. See Rule 5110(e)(2)(A)(iv).
66. See Rule 5110(g)(4). The rule change recognizes the practical issue that certain fees and expenses, including advisor or consultant fees, may be incurred before the offering is sold and allows such fees so long as the services are in connection with an offering that is completed in accordance with the agreement between the issuer and the participating member.
67. See Rule 5110(g)(7). Prior to the rule change, the application of this provision could be challenging for members, particularly in circumstances where the terms of the future offering had not been negotiated at the time of the proposed public offering. The rule change, however, retains the prohibition on any non-cash payment or fee to waive or terminate a ROFR.
68. See Rule 5110(g)(8).
69. See Rule 5110(j)(22).
70. The term “participating member” is defined to include any FINRA member that is participating in a public offering, any affiliate or associated person of the member, and any “immediate family,” but does not include the issuer. See Rule 5110(j)(15). In addition, the term “immediate family” is clarified for readability in Rule 5110(j)(8) to mean the spouse or child of an associated person of a member and any relative who lives with, has a business relationship with, provides material support to or receives material support from an associated person of a member.
71. Specifically, “issuer” is defined 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.” See Rule 5110(j)(12).
72. See Rule 5110(j)(18). Rule 5121 incorporates the definition in Rule 5110 by reference. See Rule 5121(f).
73. See Rule 5121(f)(9).

74. *See* Rule 5110(j)(2). Specifically, the term “bank” is defined 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 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.” 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).” *See* 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, note 3, (March 21, 2013).
75. *See* 17 CFR 229.508(e).
76. *See* Rule 5110(b)(1) and Supplementary Material .05 to Rule 5110. *See* also Rule 5110(e)(1)(B) requiring disclosure of lock-ups.
77. *See* Supplementary Material .05 to Rule 5110.