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FINRA Proposes Amendments To The Corporate Financing Rules

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

On April 11, 2017, the Financial Industry Regulatory Authority (FINRA) released three regulatory notices requesting comment on rules related to corporate financing and capital formation. In particular, the regulatory notices propose changes to Rule 5110, which regulates underwriting compensation and prohibits unfair arrangements in connection with the public offerings of securities; Rules 2241 and 2242, which regulate equity and debt research analysts and research reports; and Rule 2310, which relates to public offerings of direct participation programs and unlisted REIT's.

The proposed changes come as part of the FINRA360 initiative announced several months ago. Under the 360 initiative, FINRA has committed to a complete self-evaluation and improvement. As part of FINRA360, the regulator has requested public comment on the effectiveness and efficiency of its rules, operations and administrative processes governing broker-dealer activities related to the capital-raising process and their impact on capital formation.

Regulatory Notice 17-14 – Request for Comment on Rules Impacting Capital Formation

Regulatory Notice 17-14 is a request for comment on FINRA rules impacting capital formation. In its opening FINRA notes that the ability of small and large businesses to raise capital efficiently is critical to job creation and economic growth and that broker-dealers play a vital role in assisting in that process. FINRA members act as underwriters for public offerings, advisors on capital raising and corporate restructuring, placement agents for private offerings, funding portals and research analysts. Furthermore, there have been significant changes in the capital-raising processes, such as securities-based crowdfunding and Regulation A+ both initiated from the JOBS Act.

FINRA itself has made changes to modernize its regulations such as through the creation of the new Capital Acquisition Broker (CAB) and funding portal rules for brokers engaged in a limited range of fundraising activities. For more information on the CAB rules, see HERE. FINRA also seeks comments on changes that may be helpful in both the CAB and funding portal rules.

Below is a brief summary of some, but not all, the rules highlighted in FINRA Regulatory Notice 17-14.

Rules 2241 and 2242

The Regulatory Notice seeks comment on any FINRA rules that may impact capital formation, but highlights and summarizes certain rules that have significant impact on the process. For example, FINRA highlights Rule 2241 (Research Analysts and Research Reports) and Rule 2242 (Debt Research Analysts and Debt Research Reports), both of which are subject to a separate Regulatory Notice discussed in this blog.

Rule 2241 covers equity research reports and requires a separation between research and investment banking, regulates conflicts of interest and requires certain disclosures in reports and public appearances. In Regulatory Notice 17-16, FINRA proposes a safe harbor from Rule 2241 for eligible desk commentary prepared by sales and trading or principal trading personnel that may rise to the level of a research report.

Rule 2242 covers debt research reports and is similar to Rule 2241 with key differences reflecting the differences in trading of debt and equity.

Rule 2310

Rule 2310 addresses underwriting terms and arrangements in public offerings of direct participation programs (DPP's) and unlisted real estate investment trusts (REIT's). These investments tend to be complex and as such, the Rule regulates underwriter and placement agent compensation, requires due diligence and contains suitability guidelines.

The 5100 Series of Rules

The 5100 series of rules govern underwriting compensation and terms, underwriter conduct, conflicts of interest and related matters. Although there are nine rules in the 5100 Series, a few in particular most often affect the capital formation process.

Rule 5110 – Corporate Financing Rule – Underwriting Terms and Arrangements; Rule 5121 – Public Offerings of Securities with Conflicts of Interest

Rule 5110 regulates underwriting compensation and prohibits unfair arrangements in connection with the public offerings of securities. The Rule prohibits member firms from participating in a public offering of securities if the underwriting terms and conditions, including compensation, are unfair as defined by FINRA. The Rule requires FINRA members to make filings with FINRA disclosing information about offerings they participate in, including the amount of all compensation to be received by the firm or its principals, and affiliations and relationships that could result in the existence of a conflict of interest. In addition, the Rule limits certain compensation such as termination or tail fees and rights of first refusal and imposes lock-up restrictions related to the sale or transfer of securities received as compensation. The lock-up restrictions apply to a period beginning six months prior to the initial filing of a registration statement with the SEC and end 90 days following the effectiveness of the registration statement.

Where Rule 5110 requires the disclosure of affiliations, Rule 5121 goes further and prevents member firms from participating in offerings where certain conflicts of interest exist. Member firms are prohibited from participating in a public offering where certain conflicts exist, including where the issuer is controlled by or under common control with the FINRA member firm or its associated persons.

For more information on Rules 5110 and 5121, see HERE.

Rule 5122 – Private Placement of Securities Issued by Members; Rule 5123 – Private Placement of Securities

Subject to certain exceptions, such as where an offering is limited to accredited investors, Rule 5123 requires member firms to file a copy of the private placement memorandum, term sheet or other disclosure document with FINRA, for all offerings in which they sell securities, within 15 calendar days of the first sale. FINRA enacted the rule in an effort to further police the private placement market and to ensure that members participating in these private offerings conduct sufficient due diligence on the securities and their issuers.

Rule 5122 requires members that offer or sell their own securities to file the private placement memorandum, term sheet or other offering document at or prior to the first time the documents are provided to any prospective investor. Rule 5122 also establishes standards on disclosure and the use of private placement proceeds.

Rule 6432 – Compliance with Rule 15c2-11

Rule 6432 generally requires that, prior to initiating or resuming quotations in a non-exchange-listed security in a quotation medium, such as OTC Markets, a member firm must demonstrate compliance with Rule 6432 which, in turn, requires that the member firm has the information set forth in Securities Act Rule 15c2-11. Under Rule 6432, a member complies by filing a FINRA Form 211 at least three business days before the member's quotation is published or displayed in the quotation medium. In reality the processing of the Form 211 application takes much longer than three days, and often several months. Moreover, the information and review conducted by FINRA in this process can be arduous.

Regulatory 17-15 – Request for Comment on Amendments to the Corporate Financing Rule

As discussed above, Rule 5110 is the corporate financing rule regulating underwriting compensation and prohibiting unfair arrangements in connection with the public offerings of securities. Under Rule 5110, a member firm is required to submit its underwriting or other arrangements associated with a public offering and obtain a no-objection letter from FINRA before they can proceed. FINRA proposes substantial changes to modernize, simplify and clarify its provisions.

The proposed amendments will clarify what is included in determining underwriter compensation. The Rule will eliminate a limit that prevents a member and its affiliates from acquiring more than 25% of a company's stock and increase the fraction of shares sold in a private placement that a syndicate of investors can buy from 20 percent to 40 percent. Currently, underwriting compensation is defined to include a laundry list of items. The proposed amendment would define "underwriting compensation" 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 would also include "finder fees and underwriter's counsel fees, including expense reimbursements and securities." 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.

The Rule would also allow members to use formulas other than those dictated by FINRA to calculate their underwriting compensation, extend certain filing deadlines, and clarify circumstances in which stock sale restrictions don't apply.

The proposed Rule increases the filing deadline from one business day to three business days after the filing of the offering with the SEC. The Rule also reduces the number of documents that must be filed. Furthermore, if a member participating in the offering files with FINRA, other participating members will be not be required to do so.

The Rule governs all public offerings subject to exceptions. Moreover, certain offerings are not subject to the Rule, such as offerings exempt under Section 4(a)(1), 4(a)(2) or 4(a)(6) of the Securities Act.

Regulatory Notice 17-16 – Request for Comment on Proposed Safe Harbor from FINRA Equity and Debt Research Rules

As discussed above, Rule 2241 covers equity research reports and requires a separation between research and investment banking, regulates conflicts of interest and requires certain disclosures in reports and public appearances. Rule 2242 covers debt research reports and is similar to Rule 2241 with key differences reflecting the differences in trading of debt and equity.

FINRA proposes a safe harbor from Rule 2241 and 2242 for eligible desk commentary prepared by sales and trading or principal trading personnel that may rise to the level of a research report. In particular, the safe harbor would cover specified brief, written analysis distributed to eligible institutional investors that comes from sales and trading or principal trading personnel but that may rise to the level of a research report (i.e., desk commentary).

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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