



FINRA Proposes Amendments to Corporate Financing Rule:

- Broader Availability of Termination Fees and Rights of First Refusal
- Elimination of Filing for Certain ETFs

On June 6, 2012, FINRA issued proposed amendments¹ to Rule 5110 (the “Proposal”), commonly called the Corporate Financing Rule. The Corporate Financing Rule addresses commercial fairness in underwriting and other arrangements for the distribution of securities. Rule 5110 provides for review by FINRA of underwriting or other arrangements in connection with most public offerings in order to enable FINRA to assess the fairness and reasonableness of proposed underwriting compensation and arrangements.

Deferred Compensation Proposal

The Corporate Financing Rule currently limits the terms of deferred compensation provided in engagement letters between issuers and potential underwriters in connection with public offerings. As noted by FINRA, a deferred compensation arrangement responds to issuer concerns that up-front payment for financial advisory services could adversely affect the issuer’s business. The deferred compensation provisions, on the other hand, respond to the underwriter’s concern that an issuer may unreasonably terminate an engagement letter. FINRA has traditionally limited certain deferred compensation arrangements.

FINRA currently interprets Rule 5110(f)(2)(E) to permit termination fees only in exchange offers or similar transactions in which substantial structuring and advisory services beyond traditional underwriting and distribution services have been provided. A “termination fee” is a fee that permits an underwriter to receive fees if its services are terminated and the issuer consummates a similar transaction with another underwriter in lieu of the transaction subject to the engagement letter. FINRA permits a right of first refusal (“ROFR”), which grants an underwriter the right to act in an agreed-upon capacity in a subsequent financing transaction, but has interpreted the Rule to prohibit ROFRs when a member’s participation in the original transaction is terminated. In the Proposal, FINRA expressed its concern that these restrictions may “unnecessarily interfere” with the ability of issuers and underwriters to negotiate deferred or other appropriate compensation arrangements.

FINRA proposes to amend Rule 5110(f)(2)(D) to allow termination fees and ROFRs when the written agreement between the issuer and underwriter specifies that:

- the amount of the termination fee must be reasonable in relation to the services contemplated in the agreement and fees arising from services provided under an ROFR must be customary for those type of services;
- the issuer has a right of “termination for cause,” which includes the member’s material failure to provide the services contemplated in the agreement; and

¹ See Regulatory Notice 12-27, available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p126844.pdf>.

- an issuer's termination for cause eliminates any obligations with respect to any termination fee or ROFR.

The Proposal retains the Rule's current requirements that termination fees can only be paid if an offering or other transaction described in the agreement is consummated within two years of the date the engagement letter is terminated, and a ROFR cannot have a duration of more than three years from the date of effectiveness or commencement of sales of a public offering.

Elimination of Filing for Certain ETFs

Rule 5110 currently exempts exchange-traded funds ("ETFs") structured as open-ended investment companies or unit investment trusts from regulation under the Rule, including required filings with FINRA's Corporate Financing Department.² FINRA proposes to exempt from filing offerings of securities issued by an ETF formed as a grantor trust or statutory trust in which the portfolio assets include commodities, currencies or other assets that are not securities.³ FINRA states in the Proposal that the Corporate Financing Rule is not designed for the ETF distribution methodology,⁴ and that ETFs should be treated consistently, without regard to their formal legal structures, based on the nature of the securities held in the ETF's portfolio. As proposed, such ETFs will still be required to comply with the substantive requirements of Rule 5110 but will not be required to file offering documents under the Rule. The Proposal is silent on the reason to exempt such ETFs only from the filing obligation.

Ministerial Amendments

The Proposal also contains non-substantive ministerial changes to reflect the requirement that all filings under the Rule must be made electronically.⁵

Comment Deadline

The comment period on the Proposal expires July 23, 2012.

² Rule 5110(b)(8)(C).

³ Proposed new subsection (h) of Rule 5110(b)(7).

⁴ FINRA described the methodology as a "basket" of the underlying assets is deposited into the ETF's portfolio and "creation units" of shares are provided to the broker-dealer in return.

⁵ See our recent News Bulletin, "FINRA to Introduce New Electronic Filing System for Public Offerings," (May 3, 2012), available at <http://www.mofo.com/files/Uploads/Images/120503-FINRA-Electronic-Filing-System.pdf>.

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