



FINRA Releases FAQs on its Public Offering Review Process

FINRA recently released a set of frequently asked questions (“FAQs”)¹ relating to its public offering process and the Corporate Financing Rule (Rule 5110).² The guidance provided in the FAQs is summarized below.

Underwriting Compensation

Lock-up Requirements and Exemptions

Under FINRA Rule 5110(g), unregistered securities that are excluded from the calculation of underwriting compensation³ are generally subject to a 180-day lock-up. However, FINRA has provided exemptions from the lock-up requirement for securities acquired as a result of an exercise, conversion, stock split or a pro rata rights offering of securities acquired before the review period. The FAQs set forth the facts and circumstances that FINRA staff consider when determining whether to grant an exemption:

- The acquisition of the securities was required to restructure the issuer’s capitalization in order to: (i) launch the public offering; (ii) complete a merger or acquisition; (iii) reorganize its corporate structure to receive tax or other benefits; (iv) emerge from a bankruptcy proceeding; (v) facilitate a stock repurchase arrangement; or (vi) facilitate some combination of these objectives.
- The securities were registered and included as part of the underwritten public offering.
- The arrangements that resulted in the acquisition of securities during the review period were designed to benefit the issuer and were not proposed by the member firm or a shareholder affiliated with the firm.

Filing Exemption

Offerings by seasoned issuers are exempt from FINRA filing requirements. FINRA bases its “seasoned” standard on whether the issuer can satisfy the standards for filing on Form S-3 or F-3 as they existed prior to October 21, 1992.⁴ To meet those standards, the issuer must have been a reporting company for at least three years and either have “at least (1) \$150 million aggregate market value of voting stock held by non-affiliates or (2) \$100 million

¹ The FINRA FAQs are available at: <http://www.finra.org/Industry/Compliance/RegulatoryFilings/PublicOfferingSystem/FAQ>.

² FINRA Rule 5110 is available at: http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=4583&print=1.

³ Under FINRA Rule 5110(c)(1), underwriting compensation must be fair and reasonable. In determining the amount of underwriting compensation, FINRA Rule 5110(d)(5) excludes certain items.

⁴ FINRA Rule 5110(b)(7)(C)(i).

aggregate market value of voting stock held by non-affiliates and an annual trading volume of at least three million shares.”⁵

Valuing a Right of First Refusal

A right of first refusal (“ROFR”) to participate in an offering is an “item of value” to be counted as underwriter compensation if granted within 180 days of an offering even if the ROFR is added by amendment to an agreement entered into before the 180-day period. A ROFR is worth “the dollar amount that the issuer has contractually agreed to pay the underwriter to waive or terminate the ROFR.”⁶ If a dollar amount is not agreed to, which it usually is not, then the ROFR is valued at 1% of the offering proceeds.

Disclosure Requirements

Reimbursements for Underwriter’s Counsel Fees and Expenses

Where an issuer pays or reimburses an underwriter’s counsel fees and expenses (other than “blue sky” fees), such amounts must be disclosed in the Underwriting or Plan of Distribution section of the prospectus and the offering proceeds table on the cover page must include a cross-reference to this section.⁷ These costs may be aggregated with other fees and expenses that are disclosed in the prospectus as reimbursements by the issuer.

Terms of Options, Warrants and Convertible Securities

FINRA does not require disclosure of the terms of options, warrants and convertible securities granted as underwriting compensation. However, FINRA reviews the agreements to determine whether the terms would violate any FINRA rules.⁸ It should be noted that while FINRA does not require such disclosure, it is generally appropriate and customary to disclose the terms of such securities, particularly if they are different from the securities being offered by the issuer pursuant to the prospectus.

Conflicts of Interest

Government Sponsored Entities

FINRA has granted a limited exemption from the filing requirements of FINRA Rules 5110 and 5121⁹ to a government sponsored enterprise (“GSE”) conducting a public offering where an affiliate of an underwriter owned more than 10% of the GSE. FINRA granted the filing exemption due to extensive government regulation of the GSE, including periodic audits by the U.S. Government Accountability Office.

Qualified Independent Underwriters

Under FINRA Rule 5121, a member making a public offering of its own securities must hire a Qualified Independent Underwriter (“QIU”) in order to address conflicts of interest. A firm can only be a QIU if it meets the criteria in FINRA Rule 5121(f)(12). A member making an offering that requires a QIU must make representations in the filing made in the Public Offering System that the QIU meets these requirements.

⁵ FINRA Notice to Members 93-88, available at: http://finra.complanet.com/en/display/display_main.html?rbid=2403&element_id=1551.

⁶ See FINRA Rule 5110(c)(3)(ix).

⁷ See FINRA Rules 5110(c)(3) and 5110(c)(2)(C).

⁸ See FINRA Rule 5110(f)(2)(H).

⁹ FINRA Rule 5121 is available at http://finra.complanet.com/en/display/display_viewall.html?rbid=2403&element_id=4583&print=1.

REITs and DPPs

Dividend Reinvestment Programs

Under FINRA Rule 2310, Real Estate Investment Trusts (“REITs”) may not charge a sales load or commission on securities that are purchased through dividend reinvestment programs (“DRIPs”).¹⁰ The purpose of the rule is to prevent double charges to investors. However, FINRA permits unlisted REITs that calculate net asset value daily (“Daily NAV REITs”) to charge sales loads or commissions. Unlisted REITs typically do not develop as liquid a market for their securities as do listed REITs. Daily NAV REITs seek to offset this lack of liquidity by publishing daily NAVs in order to provide some guidance to investors on valuation of their securities. In FINRA’s view, Daily NAV REITs finance most of their distributions through distribution asset-based charges based on the issuer’s NAV or the per-share NAV, which would not impose a double charge on reinvested dividends. Further, the prohibition would force Daily NAV REITs to create segregated accounts for DRIP shares and would have potentially negative tax implications for investors.

Direct Participation Programs

Direct Participation Programs (“DPPs”) must follow the requirements of FINRA Rule 2310, which imposes strict underwriting standards including suitability requirements and limitations on offering expenses.¹¹ FINRA will consider a closed-end fund to be a DPP if it receives flow-through tax treatment under the Internal Revenue Code, irrespective of its legal structure.

Training and Education Meetings

FINRA Rule 2310 prohibits participation by a member in a public offering by a DPP or REIT with unfair and unreasonable offering expenses. Offering expenses include training and education (“T&E”) meetings with affiliated REITs. An unlisted REIT cannot receive reimbursement for T&E meetings from offering proceeds unless the meeting is held at an appropriate location, such as near an asset of the unlisted REIT. However, FINRA has permitted reimbursement where a REIT and an affiliated REIT split the costs of the meeting, were managed by the same sponsor, had selling agreements with the same broker-dealers, and complied with the other non-cash compensation requirements of FINRA Rule 2310. Nonetheless, any payments to broker-dealers in connection with such T&E meetings must be included in the 10% compensation cap under FINRA Rule 2310(b)(4)(ii).

Filing Process

Same Day Clearance

Filing fees for Same Day Clearance (“SDC”) should be sent immediately after the SDC filing is made with FINRA. The fee should be submitted using the FINRA file ID provided at the time the SDC filing is initially made.

Carried Forward Amounts

FINRA waives filing fees on registered but unsold securities to be carried forward on a new registration statement if they are entered in the “Details” screen of the Public Offering Filing System as “carried forward amounts.”

¹⁰ FINRA Rule 2310 is available at:

http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11706&element_id=8469&highlight=2310#r11706.

¹¹ DPPs allow investors to have direct participation in cash flow and tax benefits without requiring any active management by the investors.

Amendments to Registration Statements

Where an amendment to a registration statement does not change the amount or value of the securities being registered, FINRA's Public Offering Filing System nonetheless requires the entry of a value for the securities included therein. Filers must include the most recent Proposed Maximum Aggregate Offering Price and the number of securities being offered from the initial registration statement or latest amendment thereto.

Confidential Filings

Where a confidential filing is subsequently publicly filed,¹² the filer must enter accession numbers into the Public Offering Filing System for both the registration statement and the confidentially filed documents. The FAQs set forth the numbering systems. However, FINRA plans to change the system so that documents that are confidentially filed will not require accession numbers.

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¹² Confidential filings are made by certain foreign private issuers and by emerging growth companies under the Jumpstart Our Business Startups Act ("JOBS Act"). Our Client Alert discussing these provisions of the JOBS Act is available at: <http://www.mofocom/files/Uploads/Images/120326-The-JOBS-Act.pdf>.