FINRA—Offerings and Research

1.5 CLE Credits

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1. Presentation
2. FINRA Releases FAQs on its Public Offering Review Process
3. FINRA Issues Guidance for Private Placement Filings
4. FINRA Proposes Revised Rule Involving the Preparation and Distribution of Debt Research Reports
5. FINRA Commences Sweep Request Relating to Conflicts of Interest
6. SEC Adopts New FINRA Rule Governing Communications with the Public
7. SEC Adopts New FINRA Rule 5123 on Private Placements
MoFo Classics
Key FINRA Rules and Practice Affecting Capital Market Transactions

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GENERAL
What Is FINRA?

• “Financial Industry Regulatory Authority, Inc.”
• Created as a result of the 2007 merger of the NASD and NYSE Regulation
  • The merger was in part a response to the challenges that brokers faced in operating their businesses under two different sets of overlapping rules
• FINRA is a “self-regulatory organization,” within the meaning of the 1934 Act, and subject to the SEC’s oversight
  • FINRA can make and enforce rules -- pursue fines against member firms and their employees. As a more extreme sanction, FINRA may also exclude firms or employees from the industry.
  • Section 15(b)(8) of the 1934 Act effectively requires a broker-dealer to be a member of FINRA (unless it deals exclusively in commercial paper, bankers' acceptances or commercial bills or it effects transactions in securities only on a national securities exchange of which it is a member)
FINRA Consolidated Rules

- Since 2007, FINRA has been consolidating the rules of the NASD and NYSE Regulation – the “Consolidated Rulebook”
  - Remove duplicative rules
  - Identify differences to determine which existing rules should control
  - Process is mostly complete, but work is still being done
GENERAL RULES APPLICABLE TO MEMBER FIRMS
Rule 2110: Honor and Equity

- “A member, in the conduct of his [sic] business, shall observe high standards of commercial honor and just and equitable principles of trade.”

- Rule 2110 is implemented through a variety of rules and interpretations
Suitability – Rule 2111

• Standards revised in 2010, effective July 2012
• A member must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the facts known by the member or disclosed by the customer in response to the member’s reasonable efforts to obtain information concerning the customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the member considers to be reasonable in making recommendations.
• There are three main suitability obligations under Rule 2111:
  • “Reasonable-basis obligation” requires a member to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors
  • “Customer-specific obligation” requires that a member have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile
  • “Quantitative suitability” requires a member to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's profile
• Less rigid standard for “institutional accounts”
Know Your Customer – Rule 2090

• Every member must use due diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer
• “Essential Facts” include the customer's financial profile and investment objectives or policy
• FINRA Notice to Members 11-25 provides additional guidance on Rules 2111 and 2090.

Best Execution – New Rule 5310

• FINRA Rule Consolidation - approved October 2011; effective May 31, 2012 (replaces NASD Rule 2320):

  *In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.*

• Factors in determining “reasonable diligence”:
  • the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications
  • the size and type of transaction
  • the number of markets checked
  • accessibility of the quotation
  • terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member
Best Execution – New Rule 5310 (cont’d)

• Supplementary Material
  • How to determine price when limited pricing information available (replaces former “three quote rule”)
  • Codifies member’s obligations when it undertakes a regular and rigorous review of execution quality likely to be obtained from different market centers
  • Members’ best execution obligations when handling orders for foreign securities, and in particular foreign securities with no U.S. trading activity
  • Addressing where the customer has, on an unsolicited basis, specifically instructed the member to route its order to a particular market - member would not be required to make a best execution determination beyond that specific instruction; however, Supplementary Material mandates that members process the customer’s order promptly and in accordance with the terms of the order
FINRA & PUBLIC OFFERINGS
Offerings and FINRA Member Participation

• Role of the member in dissemination of securities
  • Public offerings
  • Private offerings

• Focus on:
  • Inexperienced or smaller issuers
  • Excessive or unfair compensation
  • Tying issuers to members for excessive period of time
  • Prevention of perceived abuses in IPOs
  • Member conflicts of interest
  • Pricing manipulation

• Disclosure and notices versus prescriptive requirements
Rule 5110 – The Corporate Financing Rule

- **Premise**: it would be contrary to high standards of commercial honor and just and equitable principles of trade for a FINRA member to participate in a distribution of securities in which the underwriting or other arrangements are unfair or unreasonable (i.e., excessive)

- The rule:
  - prohibits members from participating in such offerings; and
  - requires (in many cases) FINRA members to file specified information about offerings, which may not proceed until FINRA has provided its clearance

- An offering may be exempt from the filing requirement, but not from the rule's standards of fairness and reasonableness

- As a practical matter, the steps tend to vary considerably from an IPO to, for example, a shelf takedown
Rule 5110 – Filing Basics

• **Filing Requirements:**
  - Unless an exemption is available, certain documents and information must be filed with FINRA for every "public offering" of securities
  - Enables FINRA’s Corporate Financing Department to pass upon the fairness and reasonableness of the underwriting arrangements

• "**Public offering**":
  - Includes any registered or non-registered primary or secondary distribution that constitutes a public offering
  - Filing may be required for a public offering even where it is exempt from registration under the 1933 Act – e.g., bank notes, certain exchange offers and certain private placements

• **Excludes** private placements effected under specified 1933 Act provisions and rules, and offshore offerings under Regulation S

• **Filing fee**: $500 plus .01% of the proposed maximum aggregate offering price of the offering, not to exceed a fee of $75,500
  - The maximum fee applies to all WKSI filings
  - Fee should be paid prior to filing
Rule 5110 – Public Offering System

- Effective June 2012, FINRA changed its electronic filing system to the web-based Public Offering System (formerly COBRA)
- Members must be registered to use the system and passwords for individuals using the system must be renewed every 60 days
- Registration statements and other documents filed with the SEC via EDGAR are treated as filed with FINRA
- Filings must be made not later than one business day after filing with the SEC (or other regulatory body), or if there is no such filing, at least 15 business days prior to the anticipated offering date
- Benefits to filing even if all documents not yet available
- All filed information is generally confidential
- In many cases, FINRA will send a comment/question letter, as per the practice of the SEC and U.S. stock exchanges
Rule 5110 – Offering Effectiveness

• Interplay with the 1933 Act:
  • Rule 461(b)(6) under the 1933 Act: SEC may refuse to accelerate the effective date of a registration statement if FINRA has not signed off on the fairness of the underwriting arrangements
  • Registration statement will usually be declared effective based on telephone call from FINRA examiner to relevant SEC examiner
  • FINRA's opinion of no objections will eventually be written
Rule 5110 – The Filing

- Filing usually made by managing underwriters’ counsel
- **What is in the filing?**
  - Estimate of the maximum public offering price and the maximum underwriting discount or commission
  - Reimbursement, if any, of underwriters' expenses, including the fees of underwriters' counsel
  - Maximum financial consulting and/or advisory fees to the underwriter and related persons (as defined in the FINRA rules), and maximum finder's fees
    - Related persons include: underwriters, their counsel, financial consultants, and individuals related to the underwriters
  - Other types and amounts of compensation that may accrue to the underwriter and related persons
  - Any arrangement during the preceding six months involving issuer's transfer to the underwriter and related persons of any "items of value" or warrants, options or other securities
  - If it is claimed that certain items of value do not constitute underwriting compensation, the filing must include a statement demonstrating compliance with all of the relevant criteria
Rule 5110 – The Filing (cont'd)

• Additional Information:
  • Any association or affiliation between any FINRA member and any officer, director or 5% beneficial owner of any class of issuer's securities or any beneficial owner of any of the issuer's unregistered equity securities acquired during the six months preceding the required filing date (subject to certain exceptions)

• Underwriters’ counsel often uses a questionnaire to obtain this information from the issuer and its affiliates
Rule 5110 – Shelves

• Shelf Registration Statements
  • Offering terms and underwriters usually are not known at time of SEC filing
  • If the shelf isn’t entitled to one of the exemptions described below, the company may make the filing
  • If the filing identifies an underwriter and the full fee is paid, FINRA will issue a "no-objections" letter that will cover all future takedowns and all future underwriters; until recently, FINRA required that the prospectus (preferably in the base) state that the compensation to underwriters on any takedown will not exceed 8%; while technically not required, it is helpful disclosure
  • If the filing does not identify an underwriter, FINRA will issue a no-objections letter that covers all future takedowns; the letter is conditioned upon the future filing with FINRA of information on each individual takedown
  • Future takedowns may proceed without further FINRA clearance unless there has been a material change in the underwriting terms and arrangements

• Detailed filing guide available on the Public Offering System site
Rule 5110 – Same Day Clearance

- FINRA created a Same Day Clearance Option for certain shelf registration statements
  - Created in 2010, in response to the “need for speed” in the shelf context
  - Permits issuers and underwriters to obtain immediate no-objections letters if filings (including specified representations) are made prior to 4 p.m. on a business day
- Available for non-exempt shelf registration statements or prospectus supplements for primary offerings, but more extensive representations are required for same-day clearance of a filing in connection with a takedown
- **Not** available:
  - multi-jurisdictional disclosure system filing that is not a shelf offering
  - if final prospectus supplement for the offering has already been filed with the SEC
  - For certain issuers
- FINRA reserves the right to review transactions on a post-offering basis
Rule 5110 – Exemptions

• Certain offerings are subject to the Rule 5110 but exempt from its filing requirements, unless they are subject to the conflict of interest rules

• Securities registered with the SEC on Form S-3 or Form F-3 and offered pursuant to the shelf registration provisions of Rule 415 (applying the standards for Form S-3 and Form F-3 that applied prior to October 21, 1992)
  • 1934 Act reporting history of 36 (not 12) months
  • U.S. company must have public float of $150 million (or $100 million and an annual trading volume of three million shares) rather than the $75 million that the currently SEC requires
  • Non-U.S. company must have public float of $300 million rather than $75 million

• Canadian companies filing on F-10 under MJDS must meet standard approved in Securities Act Release No. 6902 (June 21, 1991) of C$180 million and public float at least C$75 million.

• Even a large well-followed company would have to wait three years after its IPO to qualify for an exemption from the FINRA filing requirements
Rule 5110 – Exemptions (cont'd)

• Additional Exemptions:
  • Securities (debt or equity, but not an IPO of equity securities) offered by an issuer that has unsecured non-convertible debt with a term of at least four years, or unsecured non-convertible preferred stock, that are rated “investment grade.” Similarly, an offering of investment-grade non-convertible debt securities or preferred stock, even if the issuer has no outstanding securities that have an investment-grade rating.
    • Because of these exemptions, offerings by many major issuers are not required to be filed with FINRA
    • Assumption is that issuers of this caliber have the sophistication and clout to ensure that the underwriting compensation will be reasonable
  • Certain asset-backed offerings that are rated in one of the four highest generic rating categories
• Dodd-Frank Act requires elimination of the references to rating categories by SEC (see revised Form S-3); FINRA still must address this
Rule 5110 – Underwriters’ Compensation

- Underwriters' Compensation – Items of Value
  - All items of value received or to be received from any source "in connection with or related to the distribution of the public offering," and "whether in the form of cash, securities or any other item of value"
  - Expansive list
  - Underwriter or related person may not receive securities as underwriting compensation unless they are (a) identical to the securities being offered to the public or to a security with a bona fide independent market or (b) "can be accurately valued"

- Interplay with the SEC’s disclosure rules: Item 508(e) of SEC Regulation S-K requires disclosure in the prospectus of all items that FINRA considers to be underwriting compensation – “Plan of Distribution” or similar section
Rule 5110 – Lock-Up Agreements

- Role of Underwriter Lockup Agreements
  - Subject to certain exceptions, any unregistered equity securities acquired by an underwriter during the six months prior to the required filing date or after filing and deemed to be underwriting compensation are subject to a 180-day lock-up
    - FINRA has penalized members for failure to comply
  - Longer lockup periods can provide a benefit under the Rule, which for purpose of valuing the securities permits a 10% discount for every 180 days by which the lockup period extends beyond the usual 180 days
    - Enables underwriters to “reduce the value” of securities deemed to be underwriter compensation
Rule 5110 – Standards

• Standards of Fairness:
  • Since June 2012, FINRA has a note in its Public Offering System that total proposed underwriting compensation that does not exceed 8% of the offering proceeds will be “presumed fair and reasonable”
  • In addition, FINRA has internal guidelines: the maximum permissible percentage compensation will vary depending on the overall size of the deal and the amount of risk borne by the underwriters. The FINRA staff has not formally disclosed these guidelines
    • Increased size of offering: generally less compensation is permitted
    • Amount of risk borne by underwriters: more compensation is permitted
  • IPOs: 7% underwriting discount is somewhat customary, and underwriting compensation exceeding 9% of the proceeds is often used as a rule of thumb
  • Expect negotiation and discussion with FINRA as to certain forms of compensation, including securities issuances to the underwriters
Rule 5110 – Unfair Arrangements

• FINRA deems certain arrangements to be unfair on their face, including:
  • Non-accountable expense reimbursement allowances in excess of 3% and accountable expense allowances that cover the underwriter's general overhead or similar expenses
  • Rights of first refusal on future offerings that have a duration of more than three years, that provide more than one opportunity to waive or terminate the right in consideration of any payment or fee, or that provide for waiver or termination fees that are either non-cash or that exceed specified guidelines
  • Options, warrants or convertible securities as underwriting compensation where they are exercisable or convertible for more than five years, or where the security does not meet the standards relating to registration rights, anti-dilution, and other matters set forth in the rule
  • Receipt of items for which a value cannot be determined at the time of the offering
  • Receipt of an overallotment ("green shoe") option in connection with a firm commitment underwriting if the option is in excess of 15% of the amount of securities being offered
  • Receipt from an issuer of non-cash sales incentives, including travel bonuses, prizes and awards in excess of $100 per person per issuer annually
Rule 2310 – REITS and Direct Participation Programs

- Direct participation programs ("DPP")
  - "Flow-through" tax consequences regardless of legal entity structure
  - Oil and gas limited partnerships
  - Real estate limited partnerships
  - Agricultural and cattle programs
- Does not include real estate investment trusts ("REITs")
- Parts of Rule 2310 do apply to REITs, whether in corporate or trust form
- Rule 2310 prohibits members and persons associated with members from participating in a DPP public offering, a limited partnership roll-up transaction (as defined), or, certain REIT transactions, unless the requirements of the Rule are met with respect to
  - Investor suitability
  - Disclosure obligations
  - Organization and offering expenses
  - Valuation of customer accounts,
  - Non-cash compensation.
- May apply to institutional and other investors, irrespective of FINRA member participation
Rule 5130 – “Free-Riding and Withholding”

- **Concern** – When a new offering is "hot," i.e., investors are willing to buy in the aftermarket at a higher price than the IPO price, underwriters may use their control over distribution to realize profits greater than agreed-upon underwriting spread, or to realize other benefits from preferred customers.
- FINRA Rule 5130 eliminated its historic focus on "hot issues".
- Rule 5130 applies to all "new issues," which are defined as any IPO of an equity security.
- Rule 5130 does not apply to:
  - Follow-on offerings
  - Private placements
  - Rights offerings
  - Exchange offers or offerings in connection with business combinations
  - Offerings of exempt securities, convertible securities (but not warrants or exchangeable securities), preferred securities
  - Any offering of securities that already have a market outside the United States
  - Investment-grade asset-backed securities
  - Offerings of business development companies, direct participation programs and REITs
- New issues effected offshore under Regulation S are covered by the rule. However, most underwriters will conduct these offerings through their offshore affiliates, which are not FINRA members.
Rule 5130 — Prohibitions and Exceptions

• **Prohibitions:**
  - No sale of a new issue to account in which a "restricted person" has an interest
  - No member or a person associated with a member may purchase a new issue in any account in which any of them has a beneficial interest
  - The underwriter may not continue to hold a new issue after the initial offering

• **Exceptions:**
  - Sales within a selling group that are incidental to the distribution of the new issue to non-restricted persons at the public offering price
  - Sales or purchases at the public offering price "as part of an accommodation to a non-restricted customer"
  - An underwriter may "pursuant to an underwriting agreement," place a portion of a public offering in an investment account "when it is unable to sell that portion to the public"
  - Purchases by a broker-dealer (or an owner of a broker-dealer) organized as an investment partnership if the purchases are credited to the capital accounts of the partners and if restricted persons do not have more than a 10% interest in those accounts
Rule 5130 – Restricted Persons

• Restricted Persons:
  • Any FINRA member or other broker-dealer
  • Officers, directors, general partners, employees or other associated persons of a member or any other broker-dealer, agents of a member or any other broker-dealer engaged in the investment banking or securities business, or an immediate family member of any of the foregoing if the associated person or agent materially supports or receives material support from the immediate family member, is employed by or associated with the member or an affiliate of the member that is selling the new issue to the immediate family member or has an ability to control the allocation of the new issue
  • With respect to the security being offered, a finder or any person acting in a fiduciary capacity to the managing underwriter (including but not limited to lawyers, accountants and financial consultants) or any immediate family member of a finder or fiduciary who provides or receives material support
  • Portfolio managers for different types of financial institutions, as well as certain of their immediate family members
  • Persons with significant ownership interests in a broker-dealer and certain members of their immediate family
  • Certain exemptions exist under the rule.
• Because the rule prohibits the sale of a new issue to an account in which a restricted person has a beneficial interest, non-broker-dealer subsidiaries of a broker-dealer’s holding company are also restricted
• Certain individuals who are restricted persons because of their relationship to a broker-dealer are excluded from this status if the broker-dealer is a "limited business broker-dealer," which is a broker-dealer authorized only to buy and sell investment company/variable contract securities and direct participation program securities
Rule 5130 – Preconditions

• Preconditions for Sale
  • Before selling a new issue to any account, an underwriter must have obtained within the previous 12 months a representation that all purchases of new issues are in compliance with the rule from
    • the beneficial owner of the account or an authorized representative that the account is eligible to purchase new issues in compliance with the rule or
    • a bank, foreign bank, broker-dealer or investment advisor or other conduit
  • The underwriter may not rely on any representation that it believes or has reason to believe is inaccurate. It must maintain a copy of all relevant records and documents for at least three years.
Rule 5130 – Additional Exceptions

• Rule 5130 does not apply if the securities:

  • Are specifically directed by the issuer to restricted persons; provided, however, that the securities may **not** be sold to or purchased by:
    • a broker-dealer; or
    • an account in which finders, fiduciaries and portfolio managers have a beneficial interest, unless such person, or a member of his or her immediate family, is an employee or director of the issuer, the issuer's parent, or a subsidiary of the issuer or the issuer's parent.

  • Are specifically directed by the issuer and are part of an offering in which no broker-dealer underwrites any portion of the offering, solicits or sells any new issue securities in the offering and has any involvement or influence, directly or indirectly, in the issuer's allocation decisions with respect to any of the securities in the offering.
Rule 5130 – Additional Exceptions (cont'd)

• Are part of a program sponsored by the issuer or an affiliate of the issuer that meets the following criteria:
  • the opportunity to purchase a new issue under the program is offered to at least 10,000 participants
  • every participant is offered an opportunity to purchase an equivalent number of shares, or will receive a specified number of shares under a predetermined formula applied uniformly across all participants
  • if not all participants receive shares under the program, the selection of the participants eligible to purchase shares is based upon a random or other non-discretionary allocation method
  • the class of participants does not contain a disproportionate number of restricted persons as compared to the investing public generally

• Are directed to eligible purchasers who are otherwise restricted under the Rule as part of a conversion offering in accordance with the standards of the governmental agency or instrumentality having authority to regulate such conversion offering
Rule 5130 – Additional Exceptions (cont'd)

- **Anti-dilution Provisions:** Rule 5130 does not apply to sales to an account in which a restricted person has in a beneficial interest if the account has held equity securities in the issuer (or a company acquired by the issuer within the past year):
  - for at least one year prior to the effective date of the offering
  - the sale does not increase the account's percentage interest in the issuer above the level as of three months before the offering
  - the sale does not include any special terms
  - the newly purchased securities are locked up for three months after the offering

- **Stand-by Purchasers:** Rule 5130 does not apply to sales under a written stand-by agreement that is disclosed in the prospectus for the new issue, where the managing underwriter represents in writing that it was unable to find any other purchasers for the securities and where the newly purchased securities are locked up for three months after the offering
Rule 5131 – Correcting IPO Abuses

• Addresses additional concerns raised about perceived underwriting abuses during the dot-com boom of the late 1990s - 2000
• Prohibits certain behavior during IPOs
  • “Spinning”
  • “Flipping”
  • Quid pro quo allocations
  • IPO pricing and trading practices
• Spinning and market order provisions effective September 26, 2011; all other provisions effective May 27, 2011
• “New issues” include OTC equity securities and NMS stocks
Rule 5131 – Quid Pro Quo Allocations

• Prohibits a member or person associated with a member from offering or threatening to withhold shares it allocates of a new issue as consideration or inducement for receipt of compensation that is excessive in relation to the services provided by the member
Rule 5131 – Spinning

- Allocation by underwriters of “hot” IPO shares to directors and/or executives of potential investment banking (IB) clients in exchange for investment banking services (as defined)
- Strictly prohibits IB personnel from involvement or influence, directly or indirectly, in new issue allocation decisions
- IPO shares may not be allocated to any account in which an executive officer or director of a public company or a covered non-public company, or a person materially supported (as defined) by such executive officer or director, has a beneficial interest:
  - Issuer is currently an IB services client or underwriter has received compensation from the issuer for IB services in past 12 months
  - Person responsible for making the allocation decision knows or has reason to know that underwriter intends to provide, or expects to be retained by issuer for, IB services within the next 3 months
  - Express or implied condition that such executive officer or director, on behalf of issuer, will retain underwriter for performance of future IB services
Rule 5131 – Spinning (cont'd)

• Does not apply to allocations directed in writing by issuer, its affiliates, or selling shareholders, provided that member has no involvement or influence, directly or indirectly, in such allocation decisions
  • Protects directed share and similar programs

• “Covered non-public company” is any non-public company that satisfies any of the following three conditions:
  • has income of at least $1 million in the last fiscal year or in two of the last three fiscal years and shareholders’ equity of at least $15 million
  • $30 million worth of shareholders’ equity and a two-year operating history
  • total assets and total revenue of at least $75 million in the latest fiscal year or in two of the last three fiscal years

• “Beneficial interest” is any “economic interest, such as the right to share in gains or losses” (Rule 5130)
  • Receipt of a management or performance based fee for operating a collective investment account, or other fees for acting in a fiduciary capacity, not a beneficial interest
Rule 5131 – Spinning (cont'd)

• Spinning rule does **not** apply to accounts described in Rule 5130(c)(1) – (3) and (5) – (10):
  - Registered investment companies and certain foreign investment companies
  - Certain common trust funds or insurance company general, separate or investment accounts
  - Listed public companies (or foreign private issuers that would meet listing standards)
  - ERISA and state and municipal benefit plans
  - Tax-exempt Section 501(c)(3) organizations and church plan

• Spinning rule also does **not** apply to any other account in which the beneficial interests of the affected executive officers and directors and persons materially supported by them in the aggregate do not exceed 25% of such account

• Member may rely on written representation obtained within prior 12 months from beneficial owner(s) of relevant account, or a person authorized to represent beneficial owner(s) of the account, whether such beneficial owner(s) is an executive officer or director or person materially supported by an executive officer or director and if so, the company(ies) on whose behalf such executive officer or director serves
Rule 5131 – Flipping

• No member or person associated with a member may directly or indirectly recoup, or attempt to recoup, any portion of a commission or credit paid or awarded to an associated person for selling IPO shares that are subsequently flipped by a customer, unless the managing underwriter has assessed a penalty bid on the entire syndicate.

• Flipping means initial sale of IPO shares purchased in an offering within 30 days following the offering date.

• Additional record keeping requirements.
Rule 5131 – IPO Pricing and Trading Practices

- **Reports of Indications of Interest and Final Allocations** – Requires book-running lead manager of a new issue to provide regular reports during and after final allocation regarding indications of interest and final allocations to the issuer:
  - Names of interested institutional investors and numbers of shares indicated by each of them
  - Aggregate demand from retail investors

- **Lock-Up Agreements and Other Restrictions** – Any release or waiver by underwriters of a lock-up agreement or other restriction on transfer of shares must be preceded by notice to issuer from book-running lead manager and announcement of the release or waiver in a major news service at least two business days in advance:
  - Applies only to a lock-up agreement or other restriction on the transfer of shares entered into in connection with a new issue, including issuer-directed shares
  - Supplementary materials clarify that such notice may be announced by either issuer or applicable member; however, notice requirement remains responsibility of book-running lead manager, who must ensure compliance with notice requirement
Rule 5131 – IPO Pricing and Trading Practices (cont'd)

• **Agreement Among Underwriters** – Agreements between book-running lead manager and other syndicate members must require, to extent not inconsistent with Regulation M, any shares trading at a premium to public offering price that are returned by the purchaser after commencement of secondary trading to
  • Be used to offset existing syndicate short position or
  • If no syndicate short position exists, member must either
    • Offer returned shares at public offering price to unfilled customers’ orders pursuant to a random allocation methodology or
    • Sell returned shares on secondary market and donate profits from the sale to an “unaffiliated charitable organization” with condition that donation be treated as an anonymous donation to avoid any reputational benefit to the member

• **Market Orders** – No member may accept a market order for IPO shares in the secondary market prior to commencement of trading of such shares in the secondary market
Member Conflicts of Interest

• Rule 5121, revised substantially in 2009
• Applies to a member’s participation in public offerings of securities in which the member or its affiliates have a conflict of interest
  • An "affiliate" is defined by reference to a control relationship
  • "Control" is defined as including 10% beneficial ownership of common equity, subordinated debt, preferred stock or any right to 10% or more of profits or losses, or the power to direct or cause the direction of a person's management or policies
• 2009 amendments removed requirement that a “qualified independent underwriter,” or QIU, render a pricing opinion for the securities
Rule 5121 – Conflict of Interest

• When Does a Conflict of Interest Exist?
  • The securities are to be issued by the member
  • The issuer is an “affiliate” of the member or any of its associated persons
    • This is consistently an issue for broker-dealers that underwrite securities of
      parent financial holding company
  • At least 5% of the net offering proceeds are intended to be used to repay debt to
    (or are otherwise to be directed to) the member, its affiliates or associated persons
  • As a result of the offering or any related transactions, the member becomes a
    public company, or either it or the issuer becomes an affiliate of the other
Rule 5121 – Prominent Disclosure

• A member may only participate in an offering in which it has a conflict of interest if specified “prominent disclosure” is made of the nature of the conflict, and one of the following conditions is also satisfied:
  • Securities offered have a bona fide public market, defined as:
    • Issuer has been an SEC-reporting company for at least 90 days, is current in its reporting requirements and has an average daily trading volume on a national securities exchange of at least $1 million with a float of at least $150 million
  • Securities offered are rated investment grade or are “securities in the same series that have equal rights and obligations as investment grade rated securities”
    • Test typically applies for structured note offerings in which the underwriter is affiliated with the issuer
  • Underwriter “primarily responsible for running the public offering” does not have a conflict of interest, is not an affiliate of any member with a conflict of interest and has not been the subject during the past ten years of specified criminal, civil or regulatory sanctions
  • A QIU participated in the preparation of the registration statement or other offering document, has “exercised the usual standards of ‘due diligence’” in the offering, and is identified in the prospectus as a QIU
Rule 5121 – Prominent Disclosure (cont'd)

• Prominent Disclosure requires:
  • Reference in the table of contents
  • Disclosure in the plan of distribution section

• Offering in reliance on the participation of a QIU subject to Rule 5110 filing, whether or not an exemption would otherwise be available under that rule

• Availability of other conditions makes it possible for many "conflicted" offerings to avoid Rule 5110 filing
Rule 5121 – QIU

To qualify as a QIU, a firm must meet the detailed requirements set forth in Rule 5121(f)(12):

- No conflict of interest, or be an affiliate of any FINRA member with a conflict of interest
- Must not beneficially own more than 5% of the class of securities that would give rise to a conflict of interest
- Must have agreed in writing “to undertake the legal responsibilities and liabilities of an underwriter under the Securities Act of 1933, specifically including those inherent in Section 11” (liability for a registration statement)
- The firm must have served as an underwriter in at least three public offering of a similar size and type during the past three years (rule provides a “safe harbor” standard, based on the size of the prior offerings it has underwritten and other factors)
- None of the firm’s associated persons serving in a supervisory capacity can have been the subject during the past 10 years of specified criminal, civil or regulatory sanctions

A firm wishing to qualify as a QIU in advance of a transaction may do so by providing FINRA’s Corporate Financing Department with evidence of its qualifications. FINRA will issue a letter, valid for one year, that describes the transactions for which the firm is eligible to act as a QIU. (There is no public list of eligible QIUs)

- The QIU can be a firm that is not otherwise participating in the offering
- QIU not required to be represented by independent legal counsel; however, QIUs often retain separate counsel to assist them in the transaction
Rule 5121 – Additional Provisions

- **Liability of a QIU is Unclear**: many prospectuses will state that the QIU may be deemed to be an “underwriter” within the meaning of the 1933 Act, and that the amount paid to it may be underwriting compensation. Other prospectuses are silent on the issue.

- **No Sales to Discretionary Accounts**: A member with a conflict of interest may not sell securities to a discretionary account without the specific written approval of the account holder (which may be in the form of an e-mail)
  - Prior to the 2009 amendments, the prohibition on sales to discretionary accounts applied to all firms participating in the offering, even those without any conflict of interest

- **Proceeds to be held in escrow**: All proceeds from an offering by a FINRA member must be placed in escrow, whether or not the member participates in the distribution. The funds cannot be released from escrow until the member has satisfied FINRA that it meets certain net capital standards.
  - Escrow is not required for the sale of securities of a member's holding company parent
  - Most securities firms that tap the public market on a regular basis do so through a holding company, and accordingly the escrow provision is typically not a problem
FINRA and Regulation M

- Regulation M is designed to prevent manipulation by entities such as issuers and underwriters that have an interest in the outcome of an offering
  - Prohibits activities and conduct that could artificially influence the market for an offered security
- FINRA's Market Regulation Department reviews over-the-counter trading and quoting activity for prohibited purchases and bids (or attempts to induce bids or purchases) during the applicable Regulation M restricted period, and for prohibited short sales during the five-day period prior to pricing the offering
- FINRA rules require brokers to provide FINRA with distribution-related information to facilitate the Regulation M compliance program
Regulation M

- Regulation M generally prohibits underwriters, broker-dealers, issuers and other persons participating in a distribution from directly or indirectly bidding for or purchasing the offered security (or inducing another person to do so) during the applicable “restricted period”

- Restricted period commences on later of either one or five business days prior to the determination of the offering price or such time that a person becomes a distribution participant, and ends upon such person’s completion of participation in the distribution

- To determine when the applicable restricted period under Regulation M commences, or whether no restricted period applies because the "actively traded" exception can be relied upon, the SEC has adopted a dual standard of the value of the worldwide average daily trading volume (ADTV) of the offered security and public float value of the issuer

- Regulation M also governs certain market activities (i.e., stabilizing bids, syndicate covering transactions and penalty bids) in connection with an offering and requires that notification of such activity be provided to the relevant self-regulatory organization or, in the case of stabilizing bids, the market where the stabilizing bid is to be posted

- Regulation M also prohibits any person from selling short a security that is the subject of a public offering and purchasing the security in the offering, if the short sale was effected during the restricted period (which, for purposes of the short sale restrictions, generally is the five-day period prior to pricing)
Rule 5190 and Regulation M

• FINRA Rule 5190 (Notification Requirements for Offering Participants):
  • Applies to distributions of listed and unlisted securities.
  • Rule 5190(c)(1) sets forth the notification requirements applicable to distributions of listed and unlisted securities that are "covered securities" subject to a restricted period under Rule 101 or 102 of Regulation M
  • Firms must determine whether the applicable restricted period commences one day or five days prior to pricing, and notify FINRA in writing of the firm's determination and the basis for such determination
  • Firms are required to include in the written notification the contemplated date and time of commencement of the restricted period, and identify the distribution participants and affiliated purchasers.
  • Firms are not required to submit a copy of the registration statement or other offering documents to FINRA.
  • As a practical matter, FINRA will accept a firm's notification that the five-day restricted period applies to a prospective distribution without providing the basis for that determination. If, on the other hand, a firm asserts that a one-day or no restricted period applies to a particular distribution, FINRA will require that the firm demonstrate the basis for that determination.
  • Firms must provide notification no later than the business day prior to the first complete trading session of the applicable restricted period, unless later notification is necessary under specific circumstances. (e.g., a PIPE offering is commenced and priced on the same day, and the broker cannot provide notice on the business day prior to the first complete trading session of the applicable restricted period)
  • In addition, firms must notify FINRA upon pricing a distribution that is subject to a restricted period under Regulation M
  • Firms must notify FINRA in writing if they cancel or postpone any distribution for which prior notice of commencement of the restricted period has been provided to FINRA
Rule 5190 and Regulation M (cont'd)

• Issuers and Selling Security Holders Subject to a Restricted Period (Rule 5190(c)(2)):
  • Any firm that is an issuer or selling security holder in a distribution of a security, including an "actively traded" security, subject to a restricted period under Rule 102 of Regulation M must comply with the notification requirements of Rule 5190(c)(1)
  • This requirement ensures that FINRA is notified of any distribution in which a firm is participating as an issuer or selling security holder, if notice of the distribution has not already been provided under Rule 5190

• Distributions of "Actively Traded" Securities (Rule 5190(d)):
  • Sets forth the notification requirements applicable to distributions of listed and unlisted securities that are considered "actively traded" securities and thus are not subject to a restricted period under Rule 101 of Regulation M
  • Firms must notify FINRA in writing of the firm's determination that no restricted period applies and the basis for such determination
  • Firms must notify FINRA at least one business day prior to the pricing of the distribution, unless later notification is necessary
  • Upon pricing, firms must provide written notification to FINRA, including the pricing-related information required under Rule 5190(c)(1)(B) above, and identify the distribution participants and affiliated purchasers
  • Firms must notify FINRA no later than the close of business the next business day following the pricing of the distribution, unless later notification is necessary
FINRA AND CROWDFUNDING
Title III of the JOBS Act

• April 2012, JOBS Act enacted
• Title III authorizes SEC to establish rules to permit crowdfunding
• Crowdfunding transaction must be conducted through a broker or funding portal
• New section 3(h) of the Exchange Act requires the SEC to exempt a registered funding portal from the requirement to register as a broker dealer if the funding portal:
  • remains subject to the examination, enforcement and rulemaking authority of the SEC;
  • is a member of a national securities association; and
  • is subject to such other requirements as the SEC may determine
• FINRA is only registered “national securities association”
• The SEC has not indicated when it will issue proposed rules
Broker and Funding Portal Requirements

- Register with the SEC as a broker or funding portal,
- Register with any applicable self-regulatory authority
- Provide disclosures to investors, as well as questionnaires, regarding the level of risk involved with the offering
- Ensure that all offering proceeds are only provided to issuers when the amount equals or exceeds the target offering amount, and allow for cancellation of commitments to purchase in the offering
- Ensure that no investor exceeds the investment threshold
- Must not compensate promoters, finders or lead generators
- Prohibit insiders from having any financial interest in an issuer using that intermediary's services
FINRA and Funding Portals

• in January 2013, FINRA issued a voluntary interim form for funding portals
• Form permits companies that intend to become funding portals under to voluntarily submit to FINRA information regarding their business
• FINRA expects that the information received will help it develop rules specific to funding portals
• All information provided is non-binding and will be kept confidential
• Interim form asks potential portals to provide information about:
  • ownership;
  • funding;
  • management; and
  • business model and relationships
FINRA AND PRIVATE PLACEMENTS
FINRA and Private Placements

• FINRA issued Regulatory Notice 10-22 in April 2010 reminding broker-dealers of their diligence obligations in connection with Reg D offerings
• FINRA has stated that it will focus on abuses in the private placement market
• The Notice emphasizes a broker-dealer’s obligation to conduct diligence on the issuer, management, the issuer’s business and prospects, the representations and warranties made by the issuer, and the intended uses of proceeds
• Following the issuance of Notice 10-22, FINRA has been quite active on the enforcement side taking actions against member firms in connection with private placements (including private placements involving non-traded REITs)
Rule 5123 – History

- Rule 5122 addresses private placements by member firms for the benefit of member firms or their affiliates.
- In January 2011, FINRA introduced proposed amendments to Rule 5122 to extend its reach to private placements for third party issuers in which a member firm was involved (any private placement where a member firm was an agent).
- The amendments were quite controversial, and ultimately, Rule 5122 remained applicable only to member firm private placements.
- After several changes to its proposal, FINRA adopted Rule 5123, effective December 3, 2012, which applies to other private placements where a FINRA member firm offers or sells the security or participates in the preparation of any offering or disclosure document.
Rule 5123 – General

• “Private placement” means a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act of 1933. Does not include offerings pursuant to:
  • Sections 4(1), 4(3) and 4(4) of the Securities Act
  • Sections 3(a)(2) (offerings by banks), 3(a)(9) (exchange transactions), 3(a)(10) (securities subject to a fairness hearing), or 3(a)(12) (securities issued by a bank or bank holding company pursuant to reorganization or similar transactions) of the Securities Act
  • Section 1145 of the Bankruptcy Code (securities issued in a court-approved reorganization plan that are not otherwise exempt from registration by Section 3(a)(10))

• Confidentiality provisions similar to those included in Rule 5122

• FINRA will use the documents and information filed with it solely for the purpose of determining compliance with FINRA rules or other applicable regulatory purposes

• FINRA published FAQs on Rule 5123 and the Private Offering Filing System in December 2012
Rule 5123 – Exemptions

- Offerings sold by a member solely to any one or more of the following purchasers:
  - institutional accounts, as defined in Rule 4512(c);
  - qualified purchasers and qualified institutional buyers;
  - investment companies;
  - banks;
  - employees and affiliates of the issuer;
  - knowledgeable employees as defined in Investment Company Act Rule 3c-5;
  - eligible contract participants, as defined in section 3(a)(65) of the Exchange Act; or
  - accredited investors as defined in Rule 501(a)(1), (2), (3) or (7) of the Securities Act.
Rule 5123 – Exemptions (cont’d)

- Offerings of non-convertible debt or preferred securities by issuers that meet the transaction eligibility criteria for registering primary offerings of non-convertible securities on Forms S-3 or F-3;
- Offerings made pursuant to Rule 144A or Regulation S;
- Offerings of exempted securities, as defined in section 3(a)(12) of the Exchange Act;
- Offerings of additional kinds of debt including “commercial paper,” certain subordinated loans, “variable contracts,” modified guaranteed annuity contracts and modified guaranteed life insurance policies;
- Offerings of securities issued in conversions, stock splits and restructuring transactions that are executed by an already-existing investor without the need for additional consideration or investments on the part of the investor;
Rule 5123 – Exemptions (cont’d)

- Offerings of securities of a commodity pool operated by a commodity pool operator;
- Business combination transactions;
- Offerings of registered investment companies;
- Offerings of standardized options; and
- Offerings filed with FINRA under Rules 2310, 5110, 5121, and 5122, or exempt from filing thereunder in accordance with Rule 5110(b)(7).

- Rule 5123 does not apply to crowdfunded offerings

Exemptions are applied firm-by-firm
Rule 5123 – Filing with FINRA

• Each member that sells a security in a private placement must:
  • Submit to FINRA, or have submitted on its behalf by a designated member, a copy of any private placement memorandum, term sheet, or other offering document, including any materially amended versions thereof used in connection with such sale; or
  • indicate to FINRA that no such offering documents were used.
• Filing must be made within fifteen calendar days of the date of first sale

• Filing requirement for each participating member firm or the designated member acting on their behalf
  • Filing requirement triggered by first sale by the member filing rather than first sale by another member

• **Not** required to be disclosed by FINRA:
  • anticipated use of offering proceeds or
  • the amount and type of offering expenses and compensation provided or to be provided to sponsors, finders, consultants, members and their associated persons in connection with the offering.
Other FINRA Private Placement Activity

• FINRA Regulatory Notice 09-05 – Unregistered Resales of Restricted Securities – firms reminded of their obligations to determine whether securities are eligible for public sale
• FINRA inquiries related to disclosures provided to investors about securities of privately held companies and disclosures regarding investments in special purpose vehicles formed to invest in the securities of privately held companies
RESEARCH AND COMMUNICATIONS
FINRA and Analyst Reports – Rule 2711

- Designed to address conflicts of interest in connection with the preparation and publication of research reports and public appearances relating to equity securities
- Prohibits offering favorable research to induce issuers to award investment banking business
- Imposed structural reforms to increase analyst independence, including a prohibition on investment banking personnel supervising analysts or approving research reports
- Prohibits linking analyst compensation to a specific investment banking transaction
- Prohibits submitting a research report to the issuer prior to the report's publication, with a narrow exception for verifying facts
- Mandated “quiet periods” of 40 calendar days and ten calendar days for managers and co-managers following IPOs and follow-on offerings, respectively, with exceptions for significant news or events and (in the case of follow-on offerings) for securities that meet the average daily trading volume (ADTV) test in Rule 101 of Regulation M and that also meet the requirements of SEC Rule 139
- Required increased disclosures of conflicts of interest in research reports and public appearances by analysts
- Restricts personal trading by analysts
- Requires disclosure in research reports of data and price charts showing a firm's ratings track record
Rule 2711 – 2003 Amendments (cont'd)

- Additional rules were adopted in 2003, after the enactment of Sarbanes-Oxley Act:
  - Prohibits analyst participation in efforts to solicit investment banking business (with an exception for communications “the sole purpose of which is due diligence”)
  - Applies the quiet periods following IPOs and follow-on offerings to views expressed by analysts in public appearances
  - Imposes a 25-day IPO quiet period for all participating underwriters and dealers other than managers or co-managers
  - Imposed a 15-day quiet period prior to or following the expiration, waiver or termination of a lock-up agreement (with exceptions for significant news or events and for research reports or public appearances regarding securities that meet the ADTV test in Rule 101 of Regulation M and that also meet the requirements of SEC Rule 139)
  - Members must publish a notice to customers in the event of termination of coverage of a company, with a final research report, recommendation and rating
  - Prohibits any non-research personnel reviewing or approving, with a narrow exception for reviews for the purpose of checking factual accuracy
  - Prohibits a firm from directly or indirectly "retaliating " against an analyst because of an unfavorable research report or a public statement about an investment banking client
Rule 2711 – 2005 Amendments

• Additions in June 2005:
  • Prohibit an analyst from participating in a roadshow relating to an investment banking services transaction
  • Prohibit an analyst from communicating with a customer in the presence of investment banking personnel or company management about an investment banking services transaction
  • Prohibit investment banking personnel from "directing" an analyst to engage in sales or marketing efforts related to an investment banking services transaction or to discuss such a transaction with a customer
  • Any communication by an analyst with a customer "or internal personnel" related to an investment banking services transaction must be "fair, balanced and not misleading, taking into consideration the overall context in which the communication is made"
Rule 2711 – 2012 JOBS Act Amendments

• Amendments approved October 11, 2012 to conform to changes effected by the JOBS Act for offerings by Emerging Growth Companies (“EGCs”).

  • No post-IPO or follow-on offering quiet periods for EGCs - Lock up periods discussed in Rule 2711 (f)(1), (f)(2) and (f)(4) “shall not apply to the publication or distribution of a research report or a public appearance following an initial public offering or secondary offering of the securities” of an EGC

  • Rule 2711(c)(4) was amended to provide that while research analysts are prohibited from soliciting business for investment banking, they are not prevented from attending a pitch meeting in connection with an initial public offering of an EGC that is also attended by investment banking personnel; provided, however, that a research analyst may not engage in otherwise prohibited conduct in such meetings including efforts to solicit investment banking business; effective retroactive to April 5, 2012, the date the JOBS Act was enacted.

• Impact on offering practice not yet clear
Debt Research Proposal

- FINRA Regulatory Notice – March 2011; revised February 2012 and October 2012
- Addresses conflicts of interest and relationships between debt research analysts and sales and trading personnel
- “Debt security” – security other than
  - “equity security”
  - “treasury security”
  - “municipal security”
  - security-based swaps
- Debt research reports would have same exceptions, safeguards and disclosure requirements as for equity research reports under Rule 2711
  - Requires disclosure of firm debt or equity holdings in the subject company only where such positions present a material conflict of interest
Debt Research Proposal – Prohibited Communications

• **Prohibited** Communications between Debt Analyst and Sales and Trading:
  • Sales and Trading attempting to influence Debt Analyst’s opinion or views to benefit trading position of firm, customer or class of customers
  • Debt Analysts identifying or recommending specific potential trading transactions to Sales and Trading that are not contained in such Debt Analyst’s currently published reports
  • Disclosing timing of, or material investment conclusions in, a pending debt research report
  • Any communication for purpose of determining profile of a customer to whom research should be directed
Debt Research Proposal – Permitted Communications

• **Permitted** communications between Debt Analyst and Sales and Trading:
  
  • Sales and Trading seeking information regarding issuer creditworthiness of an issuer (and other information reasonably related to the price/performance of the debt security), so long as, with respect to any covered issuer, such information is consistent with the Debt Analyst’s published research
  
  • Debt Analyst seeking factual and market information regarding a particular bond instrument, current prices, spreads, liquidity and similar market information relevant to valuation of a particular debt security
  
  • Sales and Trading providing input to Research Management regarding debt research coverage decisions, provided that final coverage decisions are made by Research Management
  
  • Certain input by Sales and Trading (not principal trading personnel) into Debt Research budget and compensation determinations
Debt Research Proposal – Institutional Investor Exemption

- Institutional investors more like debt counterparty than customer
- Institutional investors same as “institutional account” in Rule 2111 (Suitability)
- As originally drafted, all institutional investors had to opt in to receive institutional debt research. In October 2012, in response to comments that the provision was burdensome, proposal amended to presume the opt in (absent an affirmative opt out) if the institutional investor:
  - Is a Qualified Institutional Buyer (“QIB”); and
  - satisfies the FINRA Rule 2111 institutional suitability standards that require that:
    - the member firm has a reasonable basis to believe that the institutional investor is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a “debt security” or “debt securities,” as defined in the proposed debt research rules; and
    - the QIB has affirmatively indicated that it is exercising independent judgment in evaluating the firm’s recommendations pursuant to the suitability rule, provided such affirmation covers transactions in debt securities
Debt Research Proposal – Institutional Investor Exemption (cont’d)

- Proposal exempts debt research disseminated solely to institutional investors from most of the structural safeguards and disclosures that would otherwise be required with the exception of:
  - Promises of favorable research
  - Involvement of Debt Research in roadshows, pitches or other marketing
  - Input into research coverage by Investment Banking
  - Retaliation against Debt Research for unfavorable research
  - Review of research by the subject company (beyond fact-checking) or Investment Banking
  - Investment Banking directing Debt Research to engage in sales or marketing efforts or any communication with a customer about Investment Banking transaction
Debt Research Proposal – Institutional Investor Exemption (cont’d)

• Proposal would require Research to provide prominent warning on first page of report:
  • Research intended for institutional investors only and is not subject to all of the independence and disclosure standards applicable to research provided to retail investors
  • Firm trades the securities covered for own account and for certain clients; such trading interests may be contrary to recommendations offered in the research and the research may not be independent of firm’s proprietary interests (if applicable); and
  • Research may be inconsistent with recommendations offered in the firm’s research that is disseminated to retail investors (if applicable)
Debt Research Proposal – Other Exemptions

• Limited Principal Debt Trading Activity
  • Available for firms that have
    • gains or losses (in absolute value) of less than $15 million from principal debt trading activity on average over the previous three years and
    • fewer than 10 debt traders
  • Exempt from provisions that require separation between debt research analysts and those engaged in sales and trading and principal trading activities with respect to pre-publication review of debt research, supervision and compensation of debt research analysts and debt research budget determination
  • A debt trader is “a person, with respect to transactions in debt securities, who is engaged in proprietary trading or the execution of transactions on an agency basis.”
  • Firms that rely on the exemption must document the basis for their eligibility and maintain for a period of not less than three years records of any communication that, but for this exemption, would be subject to the prohibitions regarding pre-publication review by sales and trading and principal trading personnel.
Debt Research Proposal – Other Exemptions (cont’d)

• Limited Investment Banking Activity
  • Available for firms that during the previous three years, on average per year, have participated in 10 or fewer investment banking services transactions as manager or co-manager and generated $5 million or less in gross investment banking revenues from those transactions.
  • The proposal exempts eligible firms from provisions that require separation between debt research analysts and investment banking personnel with respect to pre-publication review of debt research, supervision and compensation of debt research analysts and debt research budget determination.
Communications with the Public

- NASD Rule 2210 governed communications between a member and retail investors
- NASD Rule 2211 governed institutional sales materials and correspondence
- In July 2011, FINRA proposed a comprehensive revision of current NASD Rules 2210 and 2211, related Interpretive Materials and provisions of NYSE Rule 472 that do not pertain to research analysts and research reports; proposal amended in November 2011
New Rules 2210 – 2216

• Approved by SEC in March 2012
• Effective Date: February 3, 2013
• Overview
  • Rule 2210 – subsumes and revises NASD Rules 2210 and 2211 and IMs 2210-1 and 4)
  • Rule 2211 – public communications regarding variable insurance products (IM 2210-2)
  • Rule 2212 – use of rankings in investment company sales literature and communications (former IM 2210-3)
  • Rule 2213 – requirements for use of bond mutual fund volatility rates (IM 2210-5)
  • Rule 2214 – use of investment analysis tools (IM 2210-6)
  • Rule 2215 – public communications regarding securities futures (IM 2210-7)
  • Rule 2216 – public communications regarding collateralized mortgage obligations (IM 2210-8)
Key Communications Definitions

• **Retail Communications**: written and electronic communications distributed or made available to more than 25 “retail investors” within any 30-day period

• **Correspondence**: 25 or fewer retail investors within a 30-day period

• Communications made available only to institutional investors – excludes a member’s internal communications
## FINRA Communications Rules

<table>
<thead>
<tr>
<th>Type of Communication</th>
<th>Principal Pre-Use Approval</th>
<th>FINRA Filing</th>
<th>Record-Keeping</th>
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</thead>
<tbody>
<tr>
<td><strong>Institutional Communication</strong></td>
<td>Written procedures must address education, training regarding communications</td>
<td>Not required to be filed</td>
<td>Three years from date of last use; keep on file: name of preparer, copy of communication, source of statistical information or illustration, date of first and last use, and if principal did review, then name and date of approval</td>
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<tr>
<td><strong>Retail Communication</strong></td>
<td>Requires approval before earlier of: use or filing with FINRA.</td>
<td>For new members, 10 business days prior to first use: any retail communication published or used broadly. FWPs filed with SEC may be filed within 10 days of first use.</td>
<td>Three years from date of last use. File must include: (1) copy of communication, (2) date of first use, (3) date of last use, (4) name of principal who approved, (5) date approval received, (6) if pre-approval not required because another firm filed it, name of firm and their FINRA review letter, (7) source of any statistical information or illustration</td>
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<td>Principal registration of approver will depend on type of material</td>
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<td><strong>Exceptions</strong>: Pre-approval is not required for:</td>
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<td><strong>Previously Filed Materials</strong>: (1) another firm filed it with FINRA and has received a review letter from FINRA, and (2) firm using it has not made material changes and will not use in a manner inconsistent with the FINRA letter;</td>
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<tr>
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<td>For new members, 10 business days prior to first use: any retail communication published or used broadly. FWPs filed with SEC may be filed within 10 days of first use.</td>
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<td>Within 10 business days of first use or publication: template for written reports re an investment analysis tool, a communication concerning an SEC-registered structured product, a TV or video segment</td>
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### Notes:
- **Institutional communication:**
  - written/electronic communications distributed or made available only to institutional investors
  - does not include internal communications
  - if member has “reason to believe” communication will be forwarded to retail investors, communication may be a “retail communication”
- **Retail communication:**
  - any written/electronic communication distributed or made available to more than 25 retail investors within a 30-day period
  - generally includes advertisements, sales literature, reprints
  - sales scripts intended for use with retail customers
- New 2210(c)(3)(E) includes retail communications concerning any SEC-registered security derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a currency.
## FINRA Communications Rules (cont’d)

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<tbody>
<tr>
<td>Communications excluded from research report definition and that does not include any investment recommendation;</td>
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<td>Exceptions to Filing Requirement:</td>
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<tr>
<td>Materials posted in an online forum; and</td>
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<td>1) communications previously filed, to be used without material change</td>
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<td>Any other communication that does not include an investment recommendation</td>
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<td>2) communications based on template previously filed (that will include updated statistical or changes to non-narrative info)</td>
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<td>3) materials that do not include a recommendation or promote a product</td>
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<td>4) communications that only identify an exchange symbol or a security for which the member is a market maker or offer a specific security at a price</td>
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<td>5) a prospectus or preliminary prospectus filed with SEC, or exempt from registration, EXCEPT that an FWP filed with SEC pursuant to rule 433(d)(1)(ii) is not considered a prospectus¹</td>
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¹ FWPs filed by an underwriter under Rule 433(d)(1)(ii) in a manner that will result in broad unrestricted distribution must be filed with FINRA, such as brochures posted on a public site, publicly available website pages about structured products.
## FINRA Communications Rules (cont’d)

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<td>6) communications prepared in accordance with ’33 Act Sec. 2(a)(10)(b), like rule 134 notices</td>
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<td>7) press releases available only to media</td>
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<td>8) reprints of published articles provided</td>
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<td>(a) member is not affiliated with publisher, (b) member or issuer or underwriter of any security mentioned has not commissioned, (c) member hasn’t altered contents</td>
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<td>9) correspondence</td>
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<td>10) institutional communications</td>
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<td>11) material posted on an online forum</td>
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<tr>
<td>Correspondence¹</td>
<td>Firm shall establish reasonable supervisory review process as required by Rule 3010.</td>
<td>Not required to be filed</td>
<td>Record retention requirements set out in Rule 3010.</td>
</tr>
</tbody>
</table>

¹ Correspondence: any written/electronic communication distributed or made available to 25 or fewer retail investors within a 30-day period.
FINRA Communications Rules (cont’d)

• SUBJECT TO FILING:
  • FWPs that are red herrings (filed under Rule 433(d)(1)(ii) if distributed broadly, on an unrestricted basis (“underwriter FWPs”))
  • If used broadly or on an unrestricted site:
    • a brochure
    • a product description
    • website product discussions
    • preliminary term sheets

• NOT SUBJECT TO FILING:
  • Preliminary Pricing Supplements (424(b) filings)
  • Final Pricing Supplements (424(b) filings)
  • Documents for certificates of deposit, bank notes, or 144A issuances
  • FWPs that are final term sheets, filed with the SEC
FINRA Resources

- FINRA Manual, including FINRA and NASD Rules, and rules conversion chart: [http://finra.complinet.com](http://finra.complinet.com)
FINRA Releases FAQs on its Public Offering Review Process

FINRA recently released a set of frequently asked questions (“FAQs”) relating to its public offering process and the Corporate Financing Rule (Rule 5110). 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 compensation 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. 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

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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.”

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.” 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. 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. 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 5121 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.

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6 See FINRA Rule 5110(c)(9)(ix).
7 See FINRA Rules 5110(c)(3) and 5110(c)(2)(C).
8 See FINRA Rule 5110(f)(2)(H).
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"). 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. 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.”

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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, 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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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

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FINRA Issues Guidance for Private Placement Filings

On December 3, 2012, FINRA’s new Rule 5123 went into effect. The Rule requires members selling securities issued by non-members in a private placement to file the private placement memorandum, term sheet or other offering documents with FINRA within 15 days of the date of the first sale of securities, or indicate that there were no offering documents used. In connection with the effectiveness of the Rule, FINRA issued frequently asked questions (the “Private Placement FAQs”) on the process as well as rolled out the Private Placement Filing System in the FINRA Firm Gateway.

Private Placement FAQs

The Private Placement FAQs are a mix of technical filing requirements and substantive guidance. The technical questions address how firms gain access to the Private Placement Filing System, the use of third parties, such as law firms and consultants, to make the required filings, the requirement that offering documents be filed in searchable PDF format, and the maximum size of individual documents. In addition, while a firm can designate another member participating in the private placement to file on its behalf, it should arrange to receive confirmation from the designated filer in order to satisfy its own filing obligation.

The substantive FAQs include the following:

- If there have been material changes to the offering documents that were originally filed, the amended version must be filed. FINRA notes that “Typically, the issuer will offer rescission rights to investors if there is a material change in the offering document.”

- In a contingency offering involving an escrow, FINRA, based on SEC guidance in respect of filings of Form D, takes the position that the “date of first sale” is the date on which the investor is irrevocably contractually committed to invest,” which could be the date the issuer receives the investor’s subscription agreement or check.

- Exemptions are applied on a firm-by-firm basis; different firms in the same private placement may have different filing obligations. For example, a firm that sells solely to institutional accredited investors (Rule 501(b)(1), (2), (3) or (7)), would not have to file pursuant to Rule 5123(b)(1)(J) but another firm in the same offering that sold to accredited investors that are natural persons would be required to file under Rule 5123.

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• Whether a firm that introduces a prospective investor to an issuer and receives a fee is required to file under Rule 5123 depends on the relevant facts and circumstances; there was no specific guidance beyond that warning.

• Firms participating in crowdfunding offerings under the JOBS Act will not be required to file under Rule 5123.

FINRA also notes in the Private Placement FAQs that Rule 5123 has no specific disclosure requirements, and reminds firms that they should comply with the applicable disclosure requirements of the relevant exemptions from the registration requirements of the Securities Act of 1933. FINRA also reminds firms that the antifraud provisions of the federal securities laws are applicable to the private placement offering documents.

Private Placement Filing System

Firms must file the applicable private placement offering documents (or provide notice that there are no such documents) via the Private Placement Filing System in order to satisfy their filing obligations under both new Rule 5123 and existing Rule 5122, which applies to private placements of members' securities. The new Private Placement Filing System is similar in operation to the Public Offering System implemented by FINRA in June 2012. Firms and third parties must obtain access to the FINRA Firm Gateway. FINRA has published a User Guide to the new system.3 On its website, FINRA also states that Rule 5122 and 5123 filings are “notice” filings, and that, as such, FINRA will not respond to the filings with a comment letter or provide a clearance letter.

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FINRA Proposes Revised Rule Involving the Preparation and Distribution of Debt Research Reports

On October 11, 2012, the Financial Industry Regulatory Authority (“FINRA”) issued a revised proposal to address debt research conflicts of interest that includes amending proposed exemptions for research distributed to certain institutional investors and for firms with limited principal debt trading activity. The revised proposal also includes other changes in response to comments on a prior proposal set forth in Regulatory Notice 12-09.

This alert summarizes the proposed exemptions and rule changes found in FINRA's Regulatory Notice 12-42.

Background

In February 2012, FINRA requested comment on a proposal to address debt research conflicts of interest. That proposal, set out in Regulatory Notice 12-09, generally provided retail customers with the same extensive protections provided to recipients of equity research, while exempting debt research distributed solely to eligible institutional investors (institutional debt research) from many of those structural protections, as well as prescriptive disclosure requirements.

The February 2012 proposal defined “institutional investor” as an “institutional account” in FINRA Rule 4512(c). Thus, the proposed definition would cover: (a) a bank, savings and loan association, insurance company or registered investment company; (b) an investment adviser registered either with the Securities and Exchange Commission (the “SEC”) under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (c) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million. Eligible institutional investors were required to affirmatively notify a member firm in writing if they wished to receive institutional debt research and forego the “retail” protections of the rule. The proposal also included an exemption from the review, supervision, budget and compensation provisions for broker-dealers that engage in limited investment banking activity. Regulatory Notice 12-09 also asked for input on a potential exemption for firms with limited principal trading activity or revenues generated from debt trading.

In response to comments and other industry feedback, FINRA has revised the proposed exemptions as detailed below. FINRA has requested comments on the scope and content of each of the proposed exemptions; the comment period expires on December 10, 2012.

Exemption for Institutional Debt Research

Several commenters raised issues regarding the provision that requires otherwise eligible institutional investors to affirmatively elect to receive institutional debt research. These commenters asserted that the provision is
unnecessarily burdensome and may result in excluding a significant number of institutional investors from receiving the debt research that they receive today.

FINRA now proposes to establish a higher tier of institutional investors that could receive institutional debt research without their written agreement. Instead, the broker-dealer could obtain agreement by way of negative consent, if the institutional investor chose not to notify the firm that it wishes to be treated as a retail investor. The higher tier exemption would be available to an institutional investor that:

1. meets the definition of Qualified Institutional Buyer (“QIB”); and
2. satisfies the new FINRA Rule 2111 institutional suitability standards, which require that:
   i. the member firm has a reasonable basis to believe that the institutional investor is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a “debt security” or “debt securities,” as defined in the proposed debt research rules; and
   ii. the QIB has affirmatively indicated that it is exercising independent judgment in evaluating the firm’s recommendations pursuant to the suitability rule, provided such affirmation covers transactions in debt securities.

The affirmation need not specify transactions in debt securities but must be broad enough to fairly encompass such transactions. Other institutional investors that meet the definition of FINRA Rule 4512(c), but do not satisfy the higher tier requirements, could still affirmatively elect in writing to receive institutional debt research. Retail investors could not choose to receive institutional debt research.

**Exemption for Firms with Limited Principal Debt Trading Activity**

The revised proposal includes for the first time an exemption for firms with limited principal debt trading activity. The exemption extends to firms that have (1) gains or losses (in absolute value) of less than $15 million from principal debt trading activity on average over the previous three years and (2) fewer than 10 debt traders. Firms that satisfy these criteria would be exempt from provisions that require separation between debt research analysts and those engaged in sales and trading and principal trading activities with respect to pre-publication review of debt research, supervision and compensation of debt research analysts and debt research budget determination.

For the purposes of the exemption, a debt trader is defined as “a person, with respect to transactions in debt securities, who is engaged in proprietary trading or the execution of transactions on an agency basis.” Firms that rely on the exemption must document the basis for their eligibility and maintain for a period of not less than three years records of any communication that, but for this exemption, would be subject to the prohibitions regarding pre-publication review by sales and trading and principal trading personnel.

**Exemption for Firms with Limited Investment Banking Activity**

The revised proposal maintains an exemption imported from the equity research rules for firms that engage in limited investment banking activity. Specifically, it excludes those firms that during the previous three years, on average per year, have participated in 10 or fewer investment banking services transactions as manager or co-manager and generated $5 million or less in gross investment banking revenues from those transactions. The proposal exempts eligible firms from provisions that require separation between debt research analysts and investment banking personnel with respect to pre-publication review of debt research, supervision and compensation of debt research analysts and debt research budget determination.
Other Changes

The revised proposal also makes clarifying and conforming changes in response to comments received on the proposal in Regulatory Notice 12-09. These include:

- **Definition of “debt research report”—**conforms the definition of “debt research report” to the SEC’s Regulation Analyst Certification definition and clarifies that the definition covers an analysis of either a debt security or an issuer and excludes reports on types or characteristics of debt securities. The proposal also includes all of the exceptions to the definition in the rule text.

- **Disclosure of Conflicts—**requires disclosure of material conflicts that are known or should have been known by the member firm or debt analyst at the time of publication or distribution of the report. This standard replaces the requirement in the previous proposal to disclose “all conflicts that reasonably could be expected to influence the objectivity of the debt research report.”

- **Compensation Disclosure for Foreign Sovereign Debt—**provides that, in lieu of disclosing investment banking compensation received by a non-U.S. affiliate from foreign sovereigns, firms may instead implement information barriers between that affiliate and the debt research department to prevent direct or indirect receipt of such information. However, disclosure still is required if the debt analyst has actual knowledge of receipt of investment banking compensation by the non-U.S. affiliate.

- **Road Show Prohibition—**clarifies that the prohibition applies only with respect to road shows and other marketing activities on behalf of an issuer “related to an investment banking services transaction.”

- **Prohibition on Joint Due Diligence—**deletes the provision that prohibited joint due diligence by debt research analysts and investment banking personnel, conforming to the equity research rules and a change to the Global Settlement.

- **Valuation Method Disclosure—**requires explanation of a “valuation method used” only where a specific valuation method has been employed.

- **Research Analyst Interactions with Sales and Trading—**adds clarifying language to the rule text that, in determining what is inconsistent with an analyst’s published research, firms may consider the context, including that the investment objectives or time horizons being discussed differ from those underlying the analyst’s published views.

For additional information, please see FINRA’s recently released Regulatory Notice 12-42, which can be found at the following link: [http://www.finra.org/Industry/Regulation/Notices/2012/P187304](http://www.finra.org/Industry/Regulation/Notices/2012/P187304).

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FINRA Commences Sweep Request Relating to Conflicts of Interest

In recent years, FINRA has frequently expressed concerns about conflicts of interest in the financial services industry. FINRA is now conducting a sweep of firms to review how firms identify and manage their conflicts of interest. FINRA sent its “Targeted Examination Letter” to a number of firms in July 2012, seeking information by September 14, 2012. The letter also requests a three-hour follow-up meeting during the fourth quarter of 2012 with the firms’ executive business and compliance staff. FINRA’s focus, according to the letter,1 is the firms’ approaches to conflict identification and mitigation. FINRA wants to know the most significant conflicts each firm is currently managing, and the processes the firms have in place to identify and assess whether their business practices put the firm’s or its employees’ interests ahead of those of its customers.

FINRA allays possible concerns about enforcement actions emerging from this letter (which apparently was not issued by the Department of Enforcement) by indicating that the goal of the sweep is to better understand industry practices and determine whether firms are taking reasonable steps to properly identify and manage conflicts that could affect their clients or the marketplace. FINRA indicates that it will seek to develop potential guidance for the industry. The unusual nature of the request, including the required three-hour meeting, makes it highly unlikely that FINRA would use the firms’ responses as a basis for enforcement action. However, as with any FINRA request, each broker-dealer that receives the letter should take it seriously and make sure that the information it provides is complete and accurate, and provides a positive reflection of the firm’s supervisory systems and procedures. And firms should still keep in mind that any time FINRA seeks information from a member firm, the regulator is free to commence informal or formal disciplinary action based upon that information.

The Request

The request seeks a summary of the most significant conflicts the firm is currently managing, as well as the identity of the departments and persons responsible for conducting that firm’s conflicts reviews, the reports generated from those reviews, and the departments and persons who receive those reports. The sweep request does not define “conflicts” beyond the phrase “business practices that put the firm’s or its employees’ interests ahead of those of the customers.” To understand the basis of FINRA’s interest and what exactly it is looking for, we must look to other FINRA pronouncements.

1 The letter is posted on FINRA’s website at http://www.finra.org/Industry/Regulation/Guidance/TargetedExaminationLetters/P141240
The Meaning of “Conflicts”

FINRA’s most recent public pronouncement concerning conflicts comes from the top: at FINRA’s annual conference in May 2012, CEO Rick Ketchum discussed FINRA’s efforts, in connection with making its risk-based exam program more effective and less intrusive, to make sure that firms identify conflicts and place their customers’ interests before the firm’s interests. He also put the industry on notice that FINRA would seek focused conversations with firms about the conflicts they have identified and the steps they have taken to eliminate, mitigate, or disclose each of them. Ketchum identified three ways in which firms can identify those conflicts:

- do a better job of assessing and disclosing their conflicts, that is, whether a firm’s business practices place that firm’s or its employees’ interests ahead of their customers;
- ensure that the products a firm sells—particularly complex products—are appropriate for each investor; and
- before any complex product is offered to a retail client, the financial adviser should be able to write down on a single page why this investment is in the best interests of the client.2

The need to put the customers’ interests ahead of those of the firm should be familiar to any firm adapting to FINRA’s new suitability rule, Rule 2111, which became effective on July 9 of this year. In a Regulatory Notice discussing the rule, FINRA explained that the new rule’s suitability requirement prohibits a broker from placing his or her interests ahead of the customer’s interests, a requirement that is not explicit in the rule, and that elevates the traditional suitability standard to take into consideration possible conflicts of interest.3

Further elaboration on the conflicts that have drawn FINRA’s attention is contained in FINRA’s Annual Examination Priorities Letters. Letters from recent years target the following conflicts:

- conflicts related to the sales and marketing of complex financial instruments;4
- conflicts of interest in the context of the creation and redemption process for ETFs, due to potential access by authorized participants or other key players to material information and the ability to interact directly with the ETF issuer;
- concern that the interaction of broker-dealers with non-member firms might pose conflicts of interest that might assist fraudulent schemes;
- conflicts of interest in the context of non-traded REITS—themselves the subject of a sweep letter—between the interests of investors and those of REIT managers;
- incentives in firms’ hiring practices and compensation arrangements to engage in conduct contrary to the best interests of clients; and

2 The speech is available at http://www.finra.org/newsroom/speeches/ketchum/p126481.
3 FINRA Regulatory Notice 12-25 at 3.
4 The January 31, 2012 letter refers at page 15 to “high profile civil suits against systemically important financial institutions” relating to proprietary undisclosed instruments in deals that they structured that directly conflict with the positions marketed and sold to their own clients. Presumably, this is a reference to the SEC’s well-known cases involving structuring and sales of residential mortgage-backed securities.
potential conflicts that can arise when a firm engages in a private placement to sell its own securities or those issued by an affiliate.\(^5\)

FINRA’s proactive approach to conflicts of interest can also be seen in its October 2010 Concept Proposal.\(^6\) FINRA proposed a rule that would require a firm to provide to new customers a document that sets forth the firm’s types of accounts and services, and the potential conflicts associated with those services. FINRA’s proposal would require firms to disclose, among other things, financial and other incentives that a firm or its brokers have to recommend certain products, investment strategies, or services over similar ones; this would include any arrangement in which a broker receives different payouts for certain products or services.

### Dodd-Frank’s Emphasis on Conflicts

In enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress viewed the treatment of conflicts as fundamental to customer protection. For example, Title IX of the Act directs the SEC:

- to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest; and

- to promulgate rules prohibiting or restricting sales practices, conflicts of interest, and compensation schemes for broker-dealers and investment advisers that the SEC deems contrary to the public interest and the protection of investors.\(^7\)

Moreover, in connection with asset-backed securities, Section 621 of Dodd-Frank prohibits an underwriter, placement agent, and other parties involved in the sale of an asset-backed security from engaging in certain transactions that would involve a conflict of interest. And Title VII of Dodd-Frank, regarding the regulation of over-the-counter derivatives, creates conflict-of-interest requirements throughout the new swaps-clearing environment, including requiring the CFTC and SEC to adopt rules to mitigate conflicts of interest at clearinghouses, clearing agencies, exchanges, and swap execution facilities.

### Practically Speaking

This discussion should make it obvious that the potential for a conflict of interest exists in every part of a broker-dealer’s business, and every time it deals with a customer or a business partner. FINRA’s sweep letter provides a good opportunity for firms—both those targeted by the letter and those passed over by FINRA on this round—to review their procedures for identifying and mitigating conflicts of interest, as well as to review the actual conflicts, themselves. Firms should make sure that whatever system is in place, whether overseen by a designated compliance officer or a firm-wide committee in charge of overseeing conflicts, has actually identified potential conflicts, and that there is a structure in place to determine whether the conflicts present a risk to customers that cannot be overcome or whether that risk is subject to mitigation. That system should clearly identify the personnel responsible for every supervisory procedure, and should provide for documentation of the conflicts, the conflict reviews, the mitigation strategies, and any difficulties encountered in overcoming the conflict. Moreover, firms should review the strength of their procedures regarding their information barriers; ensure that their client

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\(^5\) In its February 8, 2011 Letter, at page 7, FINRA references Rule 5122, which “plays an important part in the effort to protect investors in the private placement market where the broker-dealer or a control entity is the issuer.”

\(^6\) FINRA Regulatory Notice 10-54.

\(^7\) Dodd-Frank, Section 913.
communications about conflicts are robust; and make sure that they have adequate policies regarding taking on multiple roles in deals.

There are no guarantees, but if a firm conducts those reviews and brings its systems up to date, it is likely that its three-hour meeting with the regulators will be a more pleasant one.

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SEC Adopts New FINRA Rule Governing Communications with the Public

The Securities and Exchange Commission (the “SEC”) has approved the proposed new rules of the Financial Industry Regulatory Authority, Inc. (“FINRA”) governing communications by member firms with the public. The new rules will become effective on February 4, 2013.\(^1\)

The Communication Rules adopt the National Association of Securities Dealers, Inc. (“NASD”) Rules 2210 and 2211 and NASD Interpretive Materials 2210-1 and 2210-3 through 2210-8 as FINRA Rules 2210 and 2212 through 2216 (collectively, the “Communication Rules”), and delete certain provisions of Incorporated New York Stock Exchange (“NYSE”) Rule 472 (as well as certain supplementary material and interpretations related to this rule). These rules govern FINRA member firms’ communications with the public.

The NASD Rules being adopted generally govern all FINRA member firms’ communications with the public. NYSE Rule 472 governs these communications by firms that are also members of the NYSE.

The following is a brief summary of some of the most significant changes to the current rules governing communications with the public.

**Communication Categories**

Current NASD Rule 2210 divides communications into six categories and applies different pre-approval, filing and content standards to each. The current categories are “advertisement,” “sales literature,” “correspondence,” “institutional sales material,” independently prepared reprint” and “public appearance.” The rule change reduces the number of communication categories from six to three. The new categories are:

- **Institutional communication**: this includes written (including electronic) communications that are distributed or made available only to institutional investors, but does not include a firm’s internal communications. The new rule adopts the former definition of “institutional investor” from NASD Rule 2211 and includes registered investment companies, insurance companies, banks, registered broker-dealers, registered investment advisers, certain retirement plans, governmental entities, and individual investors and other entities with at least $50 million in assets.

- **Retail communication**: this includes any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30-calendar-day period. “Retail investor”

\(^1\) FINRA Regulatory Notice 12-29, announcing the final rules, can be found at: [http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p127014.pdf](http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p127014.pdf) (hereinafter, the “FINRA Notice”).
includes any person other than an institutional investor, regardless of whether the person has an account with the firm.

- **Correspondence:** this includes any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30-calendar-day period.

**Correspondence and Retail Communications**

Note that any written communication, if distributed to 25 or fewer retail investors during any 30-day period, is considered correspondence. On the other hand, any such communication distributed to more than 25 retail investors in any 30-day period is a retail communication. The number of recipients, therefore, will determine the pre-approval, filing and content standards applicable to the communication.

**“Reason to Believe” Standard**

FINRA Rule 2210(a)(4) provides that members may not treat communications as institutional communications if they have “reason to believe” that the communication (or any excerpt) will be forwarded to any retail investor. The rule does not impose any affirmative obligation on firms to inquire whether an institutional communication is being forwarded, or make a member firm responsible for supervising those associated with a recipient broker-dealer. However, firms should have policies and procedures designed to prevent forwarding, such as the use of legends, and appropriate training and guidance for their personnel.

If a firm becomes aware that a recipient institutional investor is forwarding communications to retail investors, the firm must treat future communications with that institutional investor as retail communications until it reasonably concludes the forwarding practice has ceased.

**Principal Pre-Use Approval Requirements for Retail Communications**

FINRA Rule 2210(b)(1)(A) requires an appropriately qualified registered principal of the firm to approve each retail communication before the earlier of its use or filing with FINRA. A Series 16 supervisory analyst approved pursuant to Incorporated NYSE Rule 344 is permitted to approve research reports on debt and equity securities, as well as retail communications that, while research-related, are not “research reports” as defined in NASD Rule 2711, provided the supervisory analyst has technical expertise in the applicable product area and has the requisite registration (e.g., the separate registration required for options or futures professionals). ²

FINRA Rule 2210(b)(1)(C) preserves the current exception from principal pre-use review for retail communications if, at the time that a firm intends to publish or distribute it, (i) another firm has filed it with FINRA and has received a letter from FINRA stating that it appears to be consistent with applicable standards and (ii) the firm using the communication in reliance on this exception has not materially altered it and will not use it in a manner that is inconsistent with the conditions of the Advertising Regulation Department’s letter.

FINRA Rule 2210(b)(1)(D) excepts from the principal pre-use approval requirements three additional categories of retail communications, provided that the firm supervises and reviews the communications. These include:

- any retail communication that is excepted from the definition of “research report” under NASD Rule 2711(a)(9)(A), unless the communication makes any financial or investment recommendation;

- any retail communication that is posted on an online interactive electronic forum; and

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² See, Supra Note 1, FINRA Notice, at 7.
any retail communication that does not make any financial or investment recommendation or otherwise
promote a product or service of the firm.

FINRA Rule 2210(b)(1)(E) allows FINRA to grant an exemption from the principal pre-use approval requirements
for good cause shown after taking into consideration all relevant factors, provided that the exemption is consistent
with the purposes of FINRA Rule 2210, the protection of investors and the public interest. FINRA has stated that
it intends to employ this exemptive authority only in unique circumstances and on a case-by-case basis.3

Supervisory and Review Requirements for Correspondence and Institutional Sales
Material

FINRA Rules 2210(b)(2) and (3) generally maintain the supervision and review standards for correspondence and
institutional communications that are currently found in NASD Rules 2211 and 3010(d).

Recordkeeping Requirements

FINRA Rule 2210(b)(4)(A) sets forth the recordkeeping requirements for retail and institutional communications,
and generally leaves in place the current recordkeeping requirements contained in NASD 2210(b)(2). This
provision incorporates by reference the recordkeeping format, medium and retention period requirements of Rule
17a-4 under the Securities Exchange Act of 1934, as amended. The records must include:

• a copy of the communication and the dates of first and (if applicable) last use;

• the name of any registered principal who approved the communication and the date that approval was
given;

• in the case of a communication that is not approved prior to first use by a registered principal, the name of
the person who prepared or distributed the communication;

• information concerning the source of any statistical table, chart, graph or other illustration used in the
communication; and

• for retail communications that rely on the exception for materials previously filed by another firm, the
name of the firm that filed the retail communication with FINRA and a copy of the Advertising Regulation
Department’s review letter.

Filing Requirements and Review Procedures

New Member Firms

FINRA Rule 2210(c)(1)(A) requires a new member firm to file its initial advertisement with the Advertising
Regulation Department at least ten days prior to its first use. This obligation continues until one year following
the effective date of the firm’s membership. To the extent any retail communication is a free writing prospectus
required to be filed with the SEC, the firm may file it within ten days of first use, rather than ten days prior to first
use.

3 See, Supra Note 1, FINRA Notice, at 8.
Firms that Depart from FINRA Standards

Under the new Rules, FINRA has maintained the prior authority of the Advertising Regulation Department to require a firm to file all of the firm’s communications if it determines that the firm has departed from FINRA standards.

Pre-Use Filing Requirements

All member firms are required to file certain communications at least ten days prior to first use, including retail communications (i) concerning any registered investment company that include self-created rankings, (ii) concerning security futures or (iii) that include bond mutual fund volatility ratings.

Concurrent with Use Requirements

FINRA Rule 2210(c)(3) requires the following to be filed within ten days of first use:

- retail communications concerning registered investment companies and public direct participation programs;
- all retail communications concerning closed-end registered investment companies;
- retail communications concerning closed-end funds that are distributed during or after the fund’s initial public offering (IPO) period;
- all advertisements and sales literature concerning continuously offered (interval) closed-end funds;
- templates for written reports produced by, or retail communications concerning, an investment analysis tool, as that term is defined in FINRA Rule 2214;
- retail communications concerning CMOs that are registered under the Securities Act of 1933;
- retail communications concerning any security that is registered under the Securities Act of 1933 and that is derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a foreign currency (i.e., structured notes); and
- if a firm has filed a draft version or “story board” of a television or video advertisement pursuant to a filing requirement, the final filmed version.

Generally consistent with current rules, the member firm must provide with each filing the actual or anticipated date of first use, the name, title and CRD number of the registered principal who approved the advertisement or sales literature and the date that the approval was given. Each firm’s written and electronic communications may be subject to a spot-check procedure, and that firms must submit requested material within the time frame specified by the Advertising Regulation Department.

Exclusions from Filing Requirements

The new FINRA rules generally duplicate the prior exclusions from the filing requirements, including exclusions for:

- material that has been filed previously or based on templates filed previously;
• materials related only to recruitment or firm name change or similar updates;

• material that does no more that identify a national securities exchange symbol for the firm or identify a security for which the firm is a registered market maker;

• material that does no more than identify the firm or offer a specific security at a stated price;

• certain “tombstone advertisements;”

• reprints of independently prepared articles;

• prospectuses filed with the SEC;

• material that refers to types of investments solely as part of a listing of products or services offered by the firm;

• communications that are posted on online interactive electronic forums; and

• press releases issued by closed-end investment companies listed on the NYSE that are subject to the NYSE’s “immediate release policy.”

**Content Standards**

FINRA Rule 2210(d)(1)(A) incorporates the basic content standards from the prior rule without change. Firm communications must be based on principles of fair dealing and good faith, be fair and balanced, and provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry or service. Firms may not omit any material fact or qualification if the omissions, in light of the context of the material presented, would cause the communication to be misleading.

A firm may not make any false, exaggerated, unwarranted or misleading statement or claim in any communication, may not publish, circulate or distribute any communication that the firm knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading and may not make any promissory statements or claims.

Information may be placed in a legend or footnote only in the event that the placement would not inhibit an investor’s understanding of the communication.

Firms must ensure that statements are not misleading within the context in which they are made, and that they provide balanced treatment of risks and potential benefits. It also requires communications to be consistent with the risks of fluctuating prices and the uncertainty of dividends, rates of return and yield inherent in investments. Firms must consider the nature of the audience to which a communication will be directed and to provide details and explanations appropriate to the audience.

The new rules carry over the current prohibition on communications that predict or project performance, while permitting a hypothetical illustration of mathematical principles, provided that the illustration does not predict or project the performance of an investment or investment strategy, but FINRA has now clarified two additional types of projections of performance are permitted. First, FINRA allows projections of performance in reports produced by investment analyst tools that meet the requirements of NASD IM-2210-6. Second, FINRA has permitted research reports on debt or equity securities to include price targets under certain circumstances.
The new rules also carry forward the prior guidance and required disclosures concerning references to tax-free or tax exempt income, as well as tax deferral, as well as the disclosure of fund sales charges and operating expense ratios.

Recommendations

Currently, the NASD rules require disclosure of certain specified conflicts of interest to the extent applicable. These disclosures include situations in which the firm:

- was making a market in the recommended securities, or the underlying security if the recommended security is an option or security future, or that the member or associated person will sell to or buy from customers on a principal basis;
- and/or its officers or partners have a financial interest in the securities of the recommended issuer and the nature of the financial interest, unless the extent of the financial interest is nominal; and
- was manager or co-manager of a public offering of any securities of the issuer whose securities are recommended in the past 12 months.

New FINRA Rule 2210(d)(7)(A) retains the first and third requirements, but modifies the second so that a retail communication that includes a recommendation of securities must disclose, if applicable, that the firm or any associated person directly and materially involved in the preparation of the content has a financial interest in any of the securities of the issuer whose securities are recommended, and the nature of the financial interest, unless the extent of the financial interest is nominal.

The Communications Rules also carry forward the current requirement that firms provide, or offer to furnish upon request, available investment information supporting the recommendation and (if the recommendation is for an equity security) to provide the price at the time the recommendation is made.

FINRA Rule 2210(d)(7)(C) amends the current provisions governing communications that include past recommendations to mirror those found in Rule 206(4)-1(a)(2) under the Investment Advisers Act of 1940. FINRA Rule 2210(d)(7)(C), like Rule 206(4)-1(a)(2), generally prohibits retail communications from referring to past specific recommendations of the firm that were or would have been profitable to any person. The rule allows, however, a retail communication or correspondence to set out or offer to furnish a list of all recommendations as to the same type, kind, grade or classification of securities made by the firm within the immediately preceding period of not less than one year. The list must provide certain information regarding each recommended security and include a prescribed cautionary legend warning investors not to assume that future recommendations will be profitable.

FINRA Rule 2210(d)(7)(D) expressly excludes from the above requirements communications that meet the definition of “research report” for purposes of NASD Rule 2711 and that include all of the applicable disclosures required by that rule. FINRA Rule 2210(d)(7)(D) also excludes any communication that recommends only registered investment companies or variable insurance products, provided that such communications must have a reasonable basis for the recommendation.

Public Appearances

Under the Communications Rules, the term “public appearance” is no longer a separate communication category. Nevertheless, FINRA Rule 2210(f) sets forth many of the same general standards that currently apply to public
appearances. If an associated person recommends a security in a public appearance, the associated person must have a reasonable basis for the recommendation. The associated person also must disclose, as applicable:

- that the associated person has a financial interest in any of the securities of the issuer whose securities are recommended, and the nature of the financial interest, unless the extent of the financial interest is nominal; and

- any other actual, material conflict of interest of the associated person or firm of which the associated person knows or has reason to know at the time of the public appearance.

Rule 2210(f) also requires firms to establish appropriate written policies and procedures to supervise public appearances, and makes clear that scripts, slides, handouts or other written (including electronic) materials used in connection with public appearances are considered communications for purposes of FINRA Rule 2210. These disclosure requirements regarding securities recommendations do not apply to (i) a public appearance by a research analyst for purposes of NASD Rule 2711 that includes all of the applicable disclosures required by that rule or (ii) a recommendation of investment company securities or variable insurance products, provided that the associated person must have a reasonable basis for the recommendation.

**Conclusion**

The Communications Rules generally will simplify the compliance task of member firms, by reducing the number of categories of communications and standardizing the pre-approval, filing and content standard applicable to each, while maintaining the core requirements of the prior NASD rules. Member firms should review their compliance policies and procedures to ensure they are in line with the Communications Rules in advance of February 2013.

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*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*
SEC Adopts New FINRA Rule 5123 on Private Placements

On June 7, 2012, the Securities and Exchange Commission (the “SEC”) approved on an accelerated basis the Financial Industry Regulatory Authority, Inc.’s (“FINRA”) proposed FINRA Rule 5123 (Private Placement of Securities) (the “Approval Order”). As approved, FINRA Rule 5123 (“FINRA Rule 5123”) requires members selling securities issued by non-members in a private placement to file the private placement memorandum, term sheet or other offering documents with FINRA within 15 days of the date of the first sale of securities, or indicate that there were no offering documents used.

As detailed below, FINRA Rule 5123 has undergone a significant transformation, including several rounds of comments and three amendments, in response to industry concerns that the proposed rule was too burdensome, resulting in the new notice filing requirement only.2

A Recap of the Background of FINRA Rule 5123

FINRA proposed new FINRA Rule 5123 (the “Proposed Rule”) on October 5, 2011.3 The Proposed Rule proved to be controversial. After receiving 16 comment letters, FINRA filed Partial Amendment No. 1 on January 19, 2012 to address the industry comments that the Proposed Rule was too burdensome.4 On January 20, 2012, the SEC instituted proceedings pursuant to Section 19(b)(2)(B) of the Securities and Exchange Act of 1934, as amended (the “Exchange Act”), to determine whether to approve or disapprove the Proposed Rule, as modified by the Partial Amendment No. 1, and sought additional comments (the “Notice and Proceedings Order”).5 The SEC received 11 comment letters in response to the Notice and Proceedings Order.6 To address the additional

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6 See the Approval Order at note 8.
comments, FINRA filed Partial Amendment No. 2 and a response letter on March 12, 2012, and Partial Amendment No. 3 to the Proposed Rule on March 22, 2012. In Partial Amendment No. 2, as further clarified by Partial Amendment No. 3, FINRA proposed to eliminate the Proposed Rule’s requirement for members to disclose specified information to investors.

In the Approval Order, the SEC stated that FINRA had addressed capital formation, competitive and efficiency concerns, including by: (i) eliminating the disclosure requirements, (ii) narrowly tailoring the rule to require only a notice filing, and (iii) creating additional exemptions under the rule. As required by the Notice and Proceedings Order, the SEC found FINRA Rule 5123, as modified, consistent with Section 15A(b)(6) of the Exchange Act, noting that FINRA narrowly tailored the broker-dealer’s obligations under FINRA Rule 5123, while enhancing its ability to carry out its statutory obligations to oversee member firms.

The Scope

FINRA Rule 5123 is significantly narrower in scope than FINRA’s original proposal. Notably, gone from the final rule are the obligations for members to:

- disclose to each investor the anticipated use of offering proceeds, the amount and type of offering expenses and offering compensation prior to sale of the securities, and
- create and provide to any potential investor a separate disclosure document containing the above information, if any issuer’s disclosure document did not contain such information.

With the elimination of the requirement that member firms provide specified disclosures to investors, FINRA Rule 5123(a) contains only a notice filing requirement, intending to address the informational needs of FINRA with respect to oversight of its members’ activities regarding private placements.

FINRA Rule 5123

Private Placements

FINRA Rule 5123 applies to a “private placement” which means, “a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act.” The definition does not apply to securities offered pursuant to:

- Sections 4(1), 4(3), and 4(4) of the Securities Act (which generally exempt secondary transactions);
- Sections 3(a)(2) (offerings by banks), 3(a)(9) (exchange transactions), 3(a)(10) (securities subject to a fairness hearing), or 3(a)(12) (securities issued by a bank or bank holding company pursuant to reorganization or similar transactions), of the Securities Act; and

8 Partial Amendment No. 3 is available at [http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p126305.pdf].
9 The Approval Order approves FINRA Rule 5123, as modified by Partial Amendments No. 1, 2 and 3. The SEC also asked for comments on Partial Amendment No. 2 and Partial Amendment No. 3. Comments are due on July 5, 2012.
10 See the SEC’s findings in Section IV of the Approval Order.
11 Section 15A(b)(6) requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.
12 The Proposed Rule, the amendments, the SEC notices, the comment letters and FINRA response letters and the Approval Order are available at [http://www.finra.org/Industry/Regulation/RuleFilings/2011/P124600].
13 The term “private placement” has the same meaning as in FINRA Rule 5122.
Section 1145 of the Bankruptcy Code (securities issued in a court-approved reorganization plan that are not otherwise entitled to the exemption from registration afforded by Securities Act Section 3(a)(10)).

Exemptions

FINRA Rule 5123 exempts other types of private placements from its notice filing requirement, including:

- offerings sold by a member solely to any one or more of the following purchasers:
  - institutional accounts, as defined in FINRA Rule 4512(c);
  - qualified purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act;
  - qualified institutional buyers, as defined in Rule 144A of the Securities Act;
  - investment companies, as defined in Section 3 of the Investment Company Act;
  - an entity composed exclusively of qualified institutional buyers, as defined in Rule 144A of the Securities Act;
  - banks, as defined in Section 3(a)(2) of the Securities Act;
  - employees and affiliates of the issuer;\(^\text{14}\)
  - knowledgeable employees as defined in Investment Company Act Rule 3c-5;
  - eligible contract participants, as defined in Section 3(a)(65) of the Exchange Act; or
  - accredited investors as defined in Rule 501(a)(1), (2), (3) or (7) of the Securities Act.

- offerings of exempted securities, as defined in Section 3(a)(12) of the Exchange Act;

- offerings made pursuant to Rule 144A under the Securities Act or Regulation S;

- offerings of exempt securities with short-term maturities under Section 3(a)(3) of the Securities Act and debt securities sold by members pursuant to Section 4(2) of the Securities Act so long as the maturity does not exceed 397 days and the securities are issued in minimum denominations of $150,000 (or the equivalent thereof in another currency);

- offerings of subordinated loans under SEA Rule 15c3-1, Appendix D;

- offerings of “variable contracts,” as defined in Rule 2320(b)(2);

- offerings of modified guaranteed annuity contracts and modified guaranteed life insurance policies, as referenced in FINRA Rule 5110(b)(8)(E);

- offerings of non-convertible debt or preferred securities by issuers that meet the transaction eligibility criteria for registering primary offerings of non-convertible securities on Forms S-3 or F-3;

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\(^{14}\) Partial Amendment No. 1 clarified that the term “affiliate” for purposes of Rule 5123 would have the same meaning as in FINRA Rule 5121. Specifically, the term “affiliate” would mean, “an entity that controls, is controlled by or is under common control with a member.”
• offerings of securities issued in conversions, stock splits and restructuring transactions that are executed by an already-existing investor without the need for additional consideration or investments on the part of the investor;

• offerings of securities of a commodity pool operated by a commodity pool operator, as defined in Section 1a(11) of the Commodity Exchange Act;

• business combination transactions as defined in Securities Act Rule 165(f);

• offerings of registered investment companies;

• offerings of standardized options, as defined in Securities Act Rule 238; and

• offerings filed with FINRA under FINRA Rules 2310, 5110, 5121 and 5122, or exempt from filing thereunder in accordance with FINRA Rule 5110(b)(7).

A member qualifies for an exemption based upon the sales it makes rather than those of all members participating in the offering. Thus, the actions of one member would not affect the availability of an exemption for another member.15

Notice Filing Requirement

FINRA Rule 5123(a) provides that each member that sells a security in a private placement must:

(i) submit to FINRA, or have submitted on its behalf by a designated member, a copy of any private placement memorandum, term sheet or other offering document, including any materially amended versions thereof used in connection with such sale, within 15 calendar days of the date of first sale; or

(ii) indicate to FINRA that no such offering documents were used.

Accordingly, a member is still obligated to file with FINRA any disclosure document used in the private placement containing the requisite information about proceeds, expenses and compensation. If no such disclosure document exists, the member must prepare a notice filing identifying the private placement and the participating members, stating that no disclosure document was used, and file it with FINRA within the filing deadline.

As described in the Approval Order, FINRA clarified during the rulemaking process several aspects relating to the filing requirement, including:

• The notice filing requirement does not establish any review and approval process by FINRA for private placements.16

• Each member participating in an offering (or a member’s designee) is required to file the disclosure document with FINRA.

• The filing requirement refers to the first sale by the member making the filing (or on whose behalf a designated member is filing), rather than the first sale by another member.

15 This was clarified by Partial Amendment No. 1.

16 See the Approval Order at note 33.
• The rule does not preclude sales of private placements in which no disclosure documents are used, and
does not require the member to make any additional disclosure to investors in such offerings.

Confidentiality

FINRA Rule 5123 provides confidential treatment to all documents and information filed pursuant to the rule, and
FINRA will use such documents and information solely for the purpose of determining compliance with FINRA
rules or other applicable regulatory purposes.

Liability

During the rulemaking process, some commenters sought clarification about the liability of members for
violations of FINRA Rule 5123. In response, FINRA stated that a wide range of regulatory responses is available
for violations of FINRA Rule 5123, as is the case for violations of any FINRA rule.17 The regulatory response
depends on the facts and circumstances of the violation, and any sanction imposed is subject to oversight and
review by the SEC.18

Conclusion

FINRA Rule 5123 imposes a new notice filing requirement on members in private placements. While it may be
good news that FINRA Rule 5123, as approved, is narrower in scope than originally proposed, member firms
should start implementing procedures designed to identify private placements covered by FINRA Rule 5123 and
to comply with the notice filing requirement.

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18 See the Approval Order at note 29, citing as an example FINRA Rule 9370 (Application to SEC for Review).