



## SEC Approves Amendments to FINRA's Corporate Financing Rule

### **Broader Availability of Termination Fees and Rights of First Refusal**

### **Elimination of Filing for Certain ETFs**

In May 2014, the SEC approved FINRA's proposed amendments to Rule 5110, commonly called the Corporate Financing Rule.<sup>1</sup> The Corporate Financing Rule addresses commercial fairness in underwriting and other arrangements for the distribution of securities. Rule 5110 provides for review by FINRA of underwriting or other arrangements in connection with most public offerings in order to enable FINRA to assess the fairness and reasonableness of proposed underwriting compensation and arrangements. In addition, the underwriters of an offering must comply with a variety of substantive provisions in Rule 5110, even if the offering is exempt from filing.

Among other changes, the amendments expand an investment bank's ability to include termination fees and rights of first refusal in engagement letters, and eliminate the requirement to file offerings of certain additional types of ETFs.

FINRA's rule revisions may be found [here](#).

### **Deferred Compensation**

The Corporate Financing Rule limits the terms of deferred compensation provided in engagement letters between issuers and investment banks in connection with private offerings as well as public offerings. As noted by FINRA, a deferred compensation arrangement responds to issuer concerns that up-front payment for financial advisory services could adversely affect the issuer's business. The deferred compensation arrangement, on the other hand, responds to the investment bank's concern that an issuer may unreasonably terminate an engagement letter and thus avoid compensating the investment bank for its efforts. FINRA has traditionally limited certain types of deferred compensation arrangements.

An investment bank typically seeks to protect itself against the risk of early termination by including in the engagement letter a "termination fee." A termination fee permits the investment bank to receive fees if its services are terminated and the issuer consummates a similar transaction instead of the transaction subject to the engagement letter. FINRA has previously interpreted Rule 5110(f)(2)(E) to permit termination fees only in

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<sup>1</sup> The SEC's approval order may be found at the following link:  
<http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p505274.pdf>.

exchange offers or similar transactions in which substantial structuring and advisory services beyond traditional underwriting and distribution services have been provided. FINRA also permits a right of first refusal (“ROFR”), which grants an investment bank the right to act in an agreed-upon capacity in a subsequent financing transaction; however, FINRA has interpreted the rule to prohibit a ROFR when a member’s participation in the original transaction is terminated.

In adopting the amendments, FINRA expressed its concern that its existing restrictions may “unnecessarily interfere” with the ability of issuers and investment banks to negotiate deferred or other appropriate compensation arrangements.

Under revised Rule 5110(f)(2)(D), FINRA will allow termination fees and ROFRs when the written engagement letter between the issuer and investment bank specifies that:

- the issuer has a right of “termination for cause,” which includes the member’s material failure to provide the underwriting services contemplated in the agreement; and
- an issuer’s termination for cause eliminates any obligations with respect to any termination fee or ROFR.

In addition, the amount of the termination fee must be reasonable in relation to the underwriting services contemplated in the engagement letter, and fees arising from underwriting services provided under a ROFR must be customary for those types of services.

The revised rule retains the prior requirements for termination fees to be paid only if an offering or other transaction described in the engagement letter is consummated within two years of the date the engagement letter is terminated, and a ROFR cannot have a duration of more than three years from the date of effectiveness or commencement of sales of a public offering. These limitations are intended, for example, to prevent an issuer from having to pay termination fees, or being subject to a ROFR, even after its business and operations may have changed significantly since the time that the original investment bank was involved in the transaction.

In addition, the revised rule continues the prior requirement that the applicable agreement may not provide the investment bank with more than one opportunity to waive or terminate the ROFR upon payment of a fee by the issuer.

In preparation for the effective date of the revised rules, investment banks may wish to revise their forms of engagement letters and similar documents to satisfy the relevant provisions.

### **Elimination of Filing for Certain ETFs**

Rule 5110 currently exempts exchange-traded funds (“ETFs”) structured as open-ended investment companies or unit investment trusts from regulation under the rule, including required filings with FINRA’s Corporate Financing Department. Under the amendment, FINRA will exempt from filing offerings of securities issued by an ETF formed as a trust, partnership, corporation, limited liability company or other collective investment vehicle in which the portfolio assets include commodities, currencies or other assets that are not securities. These types of ETFs do not register under the Investment Company Act of 1940.

FINRA stated in its rule proposal that the Corporate Financing Rule is not designed for the ETF distribution methodology, and that ETFs should be treated consistently, without regard to their formal legal structures, based on the nature of the securities held in the ETF’s portfolio. These types of ETFs will still be required to comply with the substantive requirements of Rule 5110; however, they will not be required to file offering documents under the rule.

## Ministerial Amendments Relating to Electronic Filings

The revised rule also contains non-substantive ministerial changes to help clarify the requirement that all filings under the rule be made electronically.

### Effective Date

FINRA will announce the implementation date of the rule changes in a Regulatory Notice that will be published within 60 days of the SEC's approval. The effective date of the new rules is expected to occur within 120 days after the SEC approval.

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