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FINRA Proposes Important Changes to Corporate Financing Rule to Permit the Receipt of Tail Fees and Rights of First Refusal; Separately Files to Implement an Increase in Corporate Finance Filing Fees

The Financial Industry Regulatory Authority ("FINRA") is requesting comments on proposed changes to FINRA Rule 5110 (the "Corporate Financing Rule") that would address certain deferred compensation arrangements for financial advisory services in connection with public offerings. The proposed changes principally modify Rule 5110(f), the provision that sets out the list of prohibited compensation to underwriters in connection with public offerings. If adopted, the proposed rule changes would liberalize the use of termination fees, known as tail fees, and rights of first refusal ("ROFRs"). The proposed rule changes would also eliminate the existing filing requirement for exchange-traded funds that are structured as statutory or grantor trusts and makes certain ministerial amendments to, among other things, reflect the acceptance by FINRA of filings made electronically.

In addition, FINRA has adopted an increase of the FINRA corporate finance filing fees, which will become effective July 2, 2012.

The FINRA Corporate Financing Rule

The Corporate Financing Rule is the principal rule regulating compensation to underwriters and other FINRA-member participants in public offerings of securities. The Corporate Financing Rule regulates compensation in three ways: (i) by aggregating all "items of value" received by underwriters and other related persons in connection with the public offering and deeming such items of value to be compensation in connection with the public offering and limiting that compensation as a specified percentage, usually understood as 9 percent of the gross proceeds of the public offering;

(ii) placing a prohibition on the receipt of certain items of value in connection with participation in a public offering; and (iii) requiring disclosure of all items of value that are deemed to be compensation to the underwriters in connection with the public offering. The proposed amendments liberalize the terms on which certain tail fees and rights of first refusal are permitted or prohibited under the Corporate Financing Rule.[1]

Receipt of Tail Fees under the Corporate Financing Rule

Engagement letters between underwriters and issuers often contain agreements to defer payment until after the completion of a capital-raising transaction, commonly referred to as a deferred compensation agreement. In order to address the risk that an issuer might cancel an engagement after having received substantial and valuable services from the broker-dealer (or syndicate of broker-dealers), engagement letters often provide for termination fees or ROFRs. A termination fee permits an underwriter to receive fees if its services are terminated and the issuer consummates a similar transaction with another underwriter in lieu of the transaction subject to the engagement letter. A ROFR grants an underwriter the right to act in an agreed upon capacity in a subsequent financing transaction.

By its terms, the Rule permits tail fees provided that they are limited in duration.[2] However, as interpreted by FINRA, tail fee arrangements are only permitted in connection with exchange offers.[3] In assessing the operation of the Corporate Financing Rule, FINRA found that certain restrictions on the establishment of termination fees and ROFRs in the Corporate Financing Rule may unnecessarily interfere with the ability of issuers and underwriters to negotiate deferred or other appropriate compensation arrangements that may be suited to the issuer's business interests.

While the proposed Rule would allow termination fees and ROFRs in a wider set of circumstances than is currently permitted, it would also require that the written agreement between the issuer and underwriter contain certain provisions intended to protect the issuer's right to terminate the agreement. Specifically, the proposed Rule would require:

- the amount of the termination fee to be reasonable in relation to the services contemplated in the agreement and fees arising from services provided under a ROFR must be customary for those types of services;
- the issuer to have a right of "termination for cause", which includes the member's material failure to provide the services contemplated in the agreement; and
- the issuer's right to terminate for cause must be able to eliminate any obligations with respect to any termination fee or ROFR set forth in the agreement.

[1] For more information regarding the Corporate Financing Rule, you may refer to "*FINRA regulation of corporate financing: FINRA amends rule change proposals to NASD Corporate Financing Rule 2710 and Conflict of Interest Rule 2720*" (December 2007), available at http://www.shearman.com/cm_120307/; see also "*NASD Revises Proposals to Amend the Corporate Financing Rules with Respect to Regulation of Shelf Offerings*" (May 2006), available at http://www.shearman.com/cm_051506/, and "*SEC Adopts Major Changes to NASD Corporate Financing Rule*" (April 2004), available at: http://www.shearman.com/sf_0404/.

[2] See FINRA Rule 5110(f)(2)(E), which prohibits any tail fee that "has a duration of more than two years from the date the member's services are terminated, in the event that the offering is not completed in accordance with the agreement between the issuer and the underwriter and the issuer subsequently consummates a similar transaction, except that a member may demonstrate on the basis of information satisfactory to FINRA that an arrangement of more than two years is not unfair or unreasonable under the circumstances."

[3] See NASD Notice to Members 97-82.

The proposed Rule would also retain current requirements that termination fees can only be paid in connection with an offering or other transaction described in the agreement which is consummated within two years of the date the engagement is terminated. Also retained is the prohibition on a ROFR with a duration of more than three years from the date of effectiveness or commencement of sales of a public offering. These time limitations are designed to ensure that the issuer is not subject to a termination fee or ROFR even after its business and operations may have significantly changed.

Filing Requirements for ETFs and Administrative Changes

The current Corporate Financing Rule does not contain a filing exemption for public offerings of exchange traded funds ("ETFs") that are not structured as open-end investment companies or unit investment trusts, but are instead structured as trusts with portfolio assets other than securities. The proposed Rule would accord a filing exemption to all ETFs without regard to the chosen legal structure. Accordingly, the proposed amendments would exempt from the rule's filing requirement "offerings of securities issued by ETFs formed as grantor or statutory trusts in which the portfolio assets include commodities, currencies or other assets that are not securities."[4]

Finally, the proposed rule would make several administrative amendments to certain provisions of the Corporate Financing Rule, principally relating to those provisions governing the manner in which documents must be filed with FINRA for review, in order to reflect the acceptance of electronic filing.

FINRA Filing Fee

FINRA has also adopted a revision to Section 7 of Schedule A to the FINRA By-Laws to adjust the FINRA filing fees for Rule 5110 filings.[5]

Effective July 2, 2012, FINRA will increase filing fees from 0.01% of the maximum aggregate offering amount plus $500 with a maximum of $75,500 to 0.015% of the maximum aggregate offering amount plus $500 with a maximum of $225,500. Therefore, offerings of $1.5 billion or more will pay the maximum fee under the proposed fee change. Under the fee change, the fee for any offering of securities on an automatically effective Form S-3 or F-3 registration statement filed with the SEC and offered pursuant to SEC Rule 415 by a well-known seasoned issuer will be $225,500. This will apply to any offering document required to be filed with FINRA.

Aggregate Offering Amount	Filing Fee Prior to July 2, 2012	Filing Fee After July 2, 2012
$ 100,000,000.00	$ 10,500.00	$ 15,500.00
$ 500,000,000.00	$ 50,500.00	$ 75,500.00
$ 750,000,000.00	$ 75,500.00	$ 113,000.00
$ 1,000,000,000.00	$ 75,500.00	$ 150,500.00
$ 1,500,000,000.00	$ 75,500.00	$ 225,500.00
$ 2,000,000,000.00	$ 75,500.00	$ 225,500.00
WKSI offering	$ 75,500.00	$ 225,500.00

[4] See FINRA Notice to Members 12-27.
[5] See FINRA Notice to Members 12-32.

Because the fee change represents a change in the fees of a self-regulatory organization, it will become automatically effective pursuant to Section 19(b)(3)(A) of the Securities Exchange Act. The fee change takes effect on **July 2, 2012**.

Conclusion

The relationship between issuers and underwriters is of critical import to the success of any corporate financing transaction. The understanding that tail fees and/or rights of first refusal are acceptable from a regulatory prospective under certain circumstances is therefore a welcome one, but the proposal, if adopted, will require consideration, and in some cases modification, of form documents such as engagement letters.

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