

## ADVISORY | Securities

February 13, 2013

### FINRA GUIDANCE ON PROSPECTUS DISCLOSURE OF UNDERWRITING COMPENSATION

On January 30, 2013 FINRA issued a series of FAQs regarding policies and procedures in connection with its review of public offerings. The FAQs include a discussion of the requirement in FINRA Rule 5110(c)(2)(C) that all items of underwriting compensation be disclosed in the underwriting or distribution arrangements section of a prospectus and, if there are items of underwriting compensation in addition to the underwriter's discount or commission (e.g. underwriter's FINRA counsel fee and other expenses that are paid or reimbursed by the issuer) a footnote must be added to the offering proceeds table on the cover page of the prospectus cross referencing the underwriting or distribution section. FINRA's position on footnote disclosure is new.

Now both the footnote on the cover page cross-referencing the underwriting section and disclosure in the underwriting section will be required regardless of the amount of underwriting compensation being received. (In the past FINRA had not required disclosure of FINRA counsel fees deemed underwriting compensation if the amount was *de minimis*). If the FINRA counsel fee is the only expense being reimbursed the amount will have to be disclosed. If the underwriter is being reimbursed for other expenses, however, the FINRA counsel fee may be aggregated with those other expenses.

The FAQ also addresses the following other topics:

**Rule 5110 Lock-Up Provisions** - FINRA Rule 5110(g)(1) requires that securities deemed underwriting compensation and securities that qualify for an exemption from underwriting compensation under Rule 5110 be locked up for 180 days following the SEC effective date (or date sales commence), subject to the exceptions set forth in the rule. In one FAQ, FINRA reviews the circumstances under which an exception from the lock-up provision may be permitted taking into account whether 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. FINRA also takes into consideration whether the acquisition of securities subject to the lock-up was the result of arrangements designed to benefit the issuer and was not proposed by the member firm or a shareholder affiliated with the firm.

**Rule 2310 Direct Participation Programs** - In another FAQ, FINRA notes that it has granted an exemption from Rule 2310(b)(4)(vi)'s prohibition against charging sales commissions on securities purchased through the reinvestment of dividends for unlisted real estate investment trusts ("REITs") that calculate their net asset value ("NAV") on a daily basis (Daily NAV REITs). FINRA explains that unlike more traditional REITs that charge front-end organization and offering expenses, Daily NAV REITs finance most of their distribution through asset-based charges that are calculated based on the issuer's NAV or the per share NAV. That calculation takes into account all portfolio assets and liabilities, including funds acquired through purchases of shares in a dividend reinvestment program

or DRIP. FINRA acknowledges that since the DRIP shares are the same class as the primary shares and the funds from sales of both are aggregated in the portfolio, Rule 2310 would effectively prohibit asset-based fees charged against the aggregate portfolio.

In granting the exemption, FINRA noted that Daily NAV REIT asset-based fees are similar to asset based fees charged by investment companies regulated under NASD Conduct Rule 2830. It also took into consideration the logistical burden for firms and programs to create segregated accounts for DRIP shares and the potential negative tax implications for investors.

Daily NAV REITS should confirm the exemption directly with FINRA since Rule 2310(b)(4)(vi) is still in effect.

**Government Sponsored Enterprises (“GSE”)** - FINRA granted a limited exemption from compliance with the filing requirements of Rule 5110 and the conflict provisions of Rule 5121 for the public offering of a specific GSE where the conflict of interest existed because an affiliate of the underwriter owned more than 10 percent of the GSE. In granting the exemption, FINRA notes that the particular GSE is regulated, examined and supervised by the Farm Credit Administration and periodically audited by the U.S. Government Accountability Office.

---

If you have any questions concerning the material discussed in this client advisory, please contact the following members of our securities practice group:

<b>Bruce Bennett</b>	+1.212.841.1060	<a href="mailto:bbennett@cov.com">bbennett@cov.com</a>
<b>Eric Blanchard</b>	+1.212.841.1111	<a href="mailto:eblanchard@cov.com">eblanchard@cov.com</a>
<b>Nora Gibson</b>	+1.415.591.7044	<a href="mailto:ngibson@cov.com">ngibson@cov.com</a>
<b>Frederick Knecht</b>	+1.212.841.1193	<a href="mailto:fknecht@cov.com">fknecht@cov.com</a>
<b>David Martin</b>	+1.202.662.5128	<a href="mailto:dmartin@cov.com">dmartin@cov.com</a>
<b>Marianne McKeon (Author)</b>	+1.212.841.1118	<a href="mailto:mmckeon@cov.com">mmckeon@cov.com</a>
<b>Donald Murray</b>	+1.212.841.1101	<a href="mailto:dmurray@cov.com">dmurray@cov.com</a>

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

Covington & Burling LLP, an international law firm, provides corporate, litigation and regulatory expertise to enable clients to achieve their goals. This communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to [unsubscribe@cov.com](mailto:unsubscribe@cov.com) if you do not wish to receive future emails or electronic alerts.

© 2013 Covington & Burling LLP, The New York Times Building, 620 Eighth Avenue, New York, NY 10018-1405. All rights reserved.