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FINRA Rule 6490: A Fix That Needs Fixing

When FINRA Rule 6490 was approved many thought it would streamline the process to effect a corporate change, why is it failing?

By: [Craig V. Butler, Esq.](#)

Introduction

FINRA Rule 6490 was approved by the Securities and Exchange Commission on July 1, 2010, with the stated purposes of adopting rules to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade and protect investors and the public interest. Having taken numerous clients through the 6490 process to effect corporate actions since that time it is difficult to discern whether FINRA is accomplishing the stated purposes of Rule 6490 when it was enacted, but it has become apparent that the Rule has greatly (and largely unnecessarily) impacted the way over-the-counter companies effect corporate changes. If the issues caused by Rule 6490 were a trade off for FINRA effectively achieving the stated results of the Rule then perhaps the Rule could be justified, but that does not appear to be the case. The primary issues related to the Rule are lack of communication, impossible coordination and lengthy delays. The purpose of this article is to identify these issues in the hopes of resolving them.

Background

Issuers and their attorneys do not have to go back far in time to remember when corporate changes were enacted and went effective on the over-the-counter marketplace through a series of letters to the state of incorporation, the transfer agent, CUSIP, DTC and FINRA, among others. Admittedly, the process was a bit scattered, but in the end the Issuers and/or their counsel coordinated the required shareholder and director's resolutions, the filing of the amendment to the Articles of Incorporation with the state of incorporation, obtaining the new CUSIP number, notifying the transfer agent and DTC, and working with FINRA as to when the action would go effective, sometimes on as little as three days notice. Against this backdrop FINRA proposed Rule 6490, which, when approved by the SEC, implemented a process to effect corporate actions, part of which included FINRA coordinating the corporate changes, including an application, fees, and collecting all the information from the Issuer and/or its counsel, including notarized Board of Directors and shareholder resolutions, file-stamped amendment to the Articles of Incorporation, the new CUSIP number, the transfer agent verification form, and coordinating with certain entities, such as DTC, to effect the corporate action. Initially the process appeared to work, albeit a bit slow, however, coordination was problematic. But sometime around late summer 2011 FINRA implemented a "more detailed legal review" process that it warned could significantly delay the process. In many cases this ended up being an understatement. So while the process may now be a more coordinated one, it has not shown to be streamlined in terms of communication, timing or coordination, causing issues and headaches for over-the-counter companies effecting corporate changes.

Issues with Rule 6490

Rather than deal in abstracts to outline the issues with Rule 6490, the following are three real world examples of the recent corporate changes we have effected for our clients. The relevant dates are changed but the number of days in between each significant date are the same as what actually occurred. The names of the companies are withheld, but the rest of the information is based on actual cases.

Company No. A: On August 17, 2011, Company A filed its amended Articles of Incorporation with its State of incorporation to change its name, increase its authorized common stock and authorize preferred stock, with an effective date of September 1, 2011. On August 22, 2011, Company A filed its Rule 6490 application to effect the corporate actions. Company A first heard back from FINRA on its application on August 29, 2011, wherein FINRA requested certain additional documents. The Company responded on September 8, 2011. The Company then heard back from FINRA on September 13, 2011, requesting one additional document that was not originally requested. This document was supplied on the same day, September 13, 2011. The Company then waited a week without hearing from FINRA. After one week the Company's counsel requested an update, which then seemed to trigger a response and the Company's actions went effective two days later, or on September 23, 2011. All told the process took approximately one month for a name change. There was a couple day delay caused by the Company but the remainder was waiting to hear from FINRA.

Company No. B: On November 21, 2011, Company B filed its amended Articles of Incorporation with its State of incorporation to change its name, with an effective date of December 11, 2011. On November 22, 2011, Company B filed its Rule 6490 application to effect the corporate action. Company B first heard back from FINRA on its application on November 23, 2011, wherein FINRA requested certain additional documents. The Company responded on November 24, 2011.

The Company then heard back from FINRA on November 25, 2011, in an email saying "Following an initial review, the staff will contact you via e-mail regarding any pending matters and may request additional information if deemed necessary. The omission of material information or failure to provide the required documentation will cause certain delay in completing the corporate action in the market place." Despite requests for an update on December 2, 2011, and again on December 3, 2011, the Company did not receive a response until December 9, 2011, when FINRA said "This file has been escalated for further review by management pursuant to Rule 6490. I will provide a status update when applicable. At this point I have no further information to provide."

Updates were requested often, and responses were received as follows:

December 17, 2011, "This matter is still under review. Unfortunately, I have no further information at this time."

January 24, 2012, "I had forwarded your email to my supervisor. I will follow up today in an effort to provide you with more substantive feedback."

Finally, on February 6, 2012, the Company was notified that its application had been approved, and the name and symbol change was effective on February 7, 2012. No additional documentation was ever requested after November 23, 2011, yet this seemingly simple name and symbol change took nearly two and a half months.

Company No. C: On December 16, 2011, Company C filed amended Articles of Incorporation with its State of incorporation to change its name and increase its authorized common stock, with a stated effective date of December 29, 2011. On December 23, 2011, Company C filed its 6490 application with FINRA to effect the changes. With the filing Company C included the required notarized company

Secretary's Certificate, Board of Directors and shareholders resolutions, file-stamped copy of the filed amendment to the Articles of Incorporation and the other required documents. The transfer agent verification form followed approximately one week later. Other than an auto-response e-mail, there was no word from FINRA regarding the 6490 application until January 2, 2012 (16 days after filing the application) and the only request was a copy of the company's original articles of incorporation. The e-mail correspondence from FINRA included the statement: "The Company's request will go through a lengthy review process. We ask for your patience and understanding during this time." My first thought was "now it's going through a lengthy review process? 16 days after the application was filed?" In the end the name change was approved by FINRA and effective on January 7, 2012, or three weeks after the 6490 application was filed. The action took effect with the Company's state of incorporation on January 2, 2012. This issue is discussed in detail below.

These real world examples show the issues with the Rule 6490 process and what needs fixing.

Delay: As noted above, a simple name change has taken as long as two months to go effective from the time FINRA received the 6490 application and required supporting documentation. There simply isn't a justifiable reason for such a delay. Since I am not aware how any fraud could be perpetuated by changing the name of a corporation when the company's prior names are easily discoverable, I cannot explain as to why it would take two months to approve a name change or even what could possibly need to be reviewed in that amount of time. Considering many companies change their name in connection with either a new business focus or the acquisition of a business that will be the company's business going forward, delays of two months to effect a name change could be detrimental to the company's business, potential financing or numerous other issues. It is also important to remember that for '34 Act reporting companies the 6490 process does not start until after the 14-C or 14-A requirements have been met, which between drafting, waiting periods, copies, mailing, etc. normally is at least a 45 day process (for a 14-A process when you include time for proxies to be returned or a meeting to be held) or at least 20 days (for a 14-C if you start the process after filing and mailing of Definitive 14-C) so the 6490 process is adding 2-3 weeks beyond the Proxy/Information Statement timelines causing further issues to companies needing to accomplish these tasks to further their business.

Communication: Notably in Company B and Company C examples above there were weeks of no communication from FINRA regarding the proposed company action. In particular, in Company B's situation there were numerous instances when FINRA was asked for an update and either received no response or a response that "the file is still being reviewed" with no further information. Obviously, FINRA is not alone in being slow to respond, but when combined with the other issues surrounding the 6490 process better communication would go a long way to alleviating some of the frustration.

Coordination: Although likely the least known of the issues relating to the 6490 process, the issue of coordination is the most legally troubling. Due to the facts that FINRA requires the submission of the file-stamped amendment to the Articles of Incorporation as supporting documentation for the 6490 application, the amendment when filed must have an effective date listed (normally o.k. if it is a future effective date, but depends on the state), and that the company does not know when FINRA will approve the action and take it effective, the company is stuck with a coordination issue. The company is left guessing as to the effective date it puts on the amendment to the articles. Rarely, if ever, will the future effective date listed in the amendment to the Articles of Incorporation match the date FINRA wants to take the action effective (there is some say by the company here – they can delay it going effective with FINRA by a few days, but many times the company are putting 2-3 weeks in the future for the effective date in the amendment, but FINRA is taking much longer (up to 2 months for a name change in our experience)), which leaves the company in the situation of either having the action go effective with the state before it goes effective in the public marketplace, or having to withdraw the filing with the state and re-file it once FINRA notifies the company it is ready to go effective (meaning the company technically

isn't in compliance with what FINRA wants to process a 6490 application – file-stamped amendment to the Articles of Incorporation to effect the changes). For a name change this coordination issue likely isn't material. The fact the corporate name changes with the state of incorporation prior to FINRA taking the name change effective doesn't change the fact that the company is the same legal entity during the whole process. However, for something like a stock split the lack of coordination could be a much bigger issue. It is not hard to imagine the situation where a company effects a stock split at the state level by filing the amendment to the Articles of Incorporation with an effective date that passes, but FINRA has not effected the stock split and then the company agrees to issue shares, or issues shares, or a warrant holder exercises a warrant to purchase shares, or a convertible debt holder converts the note, or any number of share issues that could occur. Are the shares pre-split or post-split? What about a merger transaction where an entity is merged out of existence in connection with a transaction that happens at the state level at one time and with FINRA at another? There are many situations where this lack of coordination could be an issue. And while the CUSIP number associated with the shares will help avoid some issues related to the common stock, but what about the issuances of convertible securities and exercises prices of convertible instruments that may be issued, etc. FINRA's explanation regarding the timing of the effective date with the state versus the effective date with FINRA has been "... it is common for the state filing and FINRA's announcement to not be on the same date. This will not cause any issues" (this was FINRA's response to my inquiry about when FINRA would take an action effective so I could coordinate the filing with the state of incorporation) doesn't cut it and does not appreciate issues that are simply not being addressed in the FINRA 6490 process.

Conclusion

The 6490 process was proposed by FINRA, and approved the SEC for the purposes of preventing fraudulent and manipulative acts and practices, promoting just and equitable principles of trade and protecting investors and the public interest. While 6490 may be having a positive effect on some of these areas, it is difficult to tell. However, what is easy to detect is the impact 6490 is having on companies attempting to effect corporate actions in a reasonable time frame. If FINRA wants to fix the situation there needs to more delineated time frames so companies can better plan on when actions may go effective. Besides an auto-response e-mail, most companies don't hear from FINRA for two weeks or so after filing an application. This is too long. If the 6490 application is complete with supporting documents and for a name change, it seems 7-10 days would be reasonable and 10-14 days for a stock split, merger, etc. There also needs to be much better communication between FINRA and companies. By communicating better with companies, the companies will be better able to plan for corporate actions and timing them with their overall business plan. Regarding coordination, the 6490 process needs to modified to much better allow for coordination between the state effective date and the FINRA effective date to stop the possible issues that could arise though the lack of coordination between these two effective periods.

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The Lebrecht Group, APLC provides comprehensive advice on a variety of corporate and securities law matters. Please contact us if you have any questions.

Craig V. Butler, Esq. is an attorney with The Lebrecht Group, APLC, located in Irvine, California and Salt Lake City, Utah. He can be reached at (949) 635-1240 or via e-mail at cbutler@thelebrechtgroup.com with questions or comments. Please visit our website at www.thelebrechtgroup.com for future updates and other information.