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May 14, 2019

Submitted via email to: rule-comments@sec.gov

Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File Number SR-FINRA-2019-12

Ladies and Gentlemen:

This letter is submitted in response to the solicitation for comments published by the U.S. Securities and Exchange Commission (the "SEC") in SEC Release No. 34-85715 (April 25, 2019),[1] with respect to proposed amendments to FINRA Rule 5110 (the "Rule" or "Rule 5110") and coordinating changes to certain other FINRA rules (together, the "Proposal").

GENERAL COMMENT

I commend FINRA's efforts to periodically review its rules to address changes in capital-raising practices and to otherwise streamline and better focus its regulation under FINRA Rule 5110 of the underwriting terms and arrangements, which has protected investors in public offerings since 1970. For the most part, the Proposal represents, as FINRA intended, a significant clarification and modernization of the Rule that will facilitate review of public offerings to the benefit of the securities industry.

Opposition to Expanding the "Review Period:" However, I am particularly concerned about the impact of the Proposal to expand the scope of the Rule to, for the first time, require the filing of information regarding and inclusion in underwriting compensation of securities anticipated to be purchased from the public offering by a participating member, except when the purchaser is covered by the definition of "issuer." This significant change in the scope of the Rule is the result of including the distribution of the public offering in the proposed definition of "review period." Set forth below are detailed reasons as to why I believe that this change is inappropriate and unnecessary, as well as inconsistent with FINRA's efforts to better focus the rule on potential problematic underwriting arrangements.

[1] SEC Release No. 34-85715 (April 25, 2019); 84 Fed. Reg. 18592 (May 1, 2019) (the "SEC Release"). *See*, also, FINRA Regulatory Notice 17-15 (April 2017) requesting comment on FINRA's initial version of the proposed amendments to Rules 5110 and 5121 (the "FINRA Notice").

Support for the Inclusion of a Principles-Based Review: The current Rule requires that any item of value acquired or arranged for by a participating member within the pre-offering 180-day review period be included in underwriting compensation.[2] Therefore, I support the more principles-based approach of the Proposal to only include in underwriting compensation those payments or benefits that are acquired or arranged for by participating members for typical services that are provided to the issuer in connection with the distribution of a public offering.

The criteria for identifying items that may be included in underwriting compensation are contained in the proposed definition of "underwriting compensation" in proposed Rule 5110(j)(22). As proposed, underwriting compensation would include ". . . any payment, right, interest, or a benefit received or to be received by a participating member from any source for underwriting, allocation, distribution, advisory and other investment banking services in connection with a public offering. In addition, underwriting compensation shall include finder's fees, underwriter's counsel fees, and securities."[3] Therefore, although a participating member may receive or arrange for a payment from the issuer or other source for a service during the pre-offering 180-day review period, FINRA is proposing that such payment will only be included in underwriting compensation if the payment meets the dual-standards proposed in Rule 5110(j)(22) as being:

1. a payment for the kind of services provided to distribute a public offering; and
2. in connection with the specific public offering.

In this connection, I welcome FINRA's proposal to adopt Supplementary Materials .02 and .03 that would establish principles-based criteria for determining whether securities can be excluded from underwriting compensation that are acquired: (1) in a venture capital transaction after filing date in the case of a delayed offering; or (2) from a source other than the issuer.

Support for Other Proposed Amendments: Other proposed amendments that will help to reduce unnecessary burdens of compliance with the Rule and will otherwise facilitate compliance include the:

1. extension of the required time for the filing of an offering with FINRA from one to three business days;
2. reduction of the documents and information required to be filed and streamlining the filing process for shelf offerings;
3. exclusion of the "issuer" from the definition of "participating member;"
4. expanded list of the items that may be included and are excluded from underwriting compensation as set forth in Supplementary Material .01;
5. new underwriting compensation exception for securities acquired in private placements as a co-investor with certain regulated entities;
6. inclusion of the specific criteria to qualify for the shelf offering exemptions from filing;

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[2] Rule 5110(d)(1).

[3] *See,* discussion of this proposal in SEC Release, at 18595. *See, also,* proposed Supplementary Material .01 that would provide welcome guidance by expanding the lists of items that may be included and not included in underwriting compensation.

7. expansion of the filing exemption for exchange offers to convertible securities;
8. expansion of the rule exemptions to closed end "tender offer" funds, insurance contracts, and unit investment trusts; and
9. defining that the review period for a shelf takedown commences 180 days prior to the required filing date of the takedown (rather than the initial filing of the shelf offering).

In some cases, a proposed amendment represents a much-needed correction of current requirements, such as the proposal to revise current Rule 5110(f)(2)(K), which would be renumbered as Rule 5510(g)(11). This provision prohibits a FINRA member's participation in an offering if the issuer hires any unregistered person to distribute or assist in distributing securities. The Proposal would revise the provision so that the prohibition will no longer be limited to situations involving a "non-underwritten issue of securities."

SPECIFIC COMMENTS[4]

The "Issuer" Exception from the Definition of "Participating Member" Should Be Further Clarified – Proposed Rule 5110(j)(15)

FINRA's proposal in the FINRA Notice to exclude persons within the definition of "issuer" from the definition of "participating member" received approving comments.[5] It was anticipated that this change would address the continued problematic application of the Rule to situations where a FINRA member is participating in an offering of its own securities or those of an affiliate, which results in persons within the definition of "issuer" also being within the definition of "participating member."

I joined with another commenter to the FINRA Notice that expressed concern that the welcome addition of "other than the issuer" to the definition of "participating member" in proposed Rule 5110(j)(15) "does not make it clear that the issuer is exempted from all categories of participating member."[6] A better understanding as previously requested in response to the FINRA Notice is particularly needed in light of FINRA's advice in the SEC Release that FINRA members should continue to seek exemptive relief in the case of offerings by FINRA members affiliated with the issuer, as further discussed below.[7]

This is to respectfully request that FINRA publish an explanation of how FINRA anticipates that the exception from "participating member" for persons within the definition of "issuer" will operate in various circumstances under different requirements of Rule 5110, including the extent to which the "issuer" is exempted from all categories of "participating

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[4] The specific comments are arranged by the subject of the comment, rather than in the order of the proposed Rule number of the provision discussed. This is to suggest a minor editorial change to proposed Rule 5110(d)(5)(C)(i) to insert a comma after the phrase "none of whom is an affiliate of a member participating in the offering."
[5] Proposed Rules 5110(j)(12) and (15). *See,* SEC Release, at 18615.
[6] SEC Release, at 18615.
[7] SEC Release, at 18610.

member." FINRA should particularly provide advice as to the extent to which persons included in the "issuer" definition are excluded from being treated as a "participating member" for purposes of the information filing requirements and calculation of underwriting compensation.

An Exclusion for Certain Securities and Other Compensation in a Member Offering Should Be Adopted – Proposed Supplementary Material .01(b)

Introduction: In its comment letter on the initial version of the proposed amendments to the Rule published in the FINRA Notice, the Securities Industry and Financial Markets Association ("SIFMA") recommended that FINRA revise proposed Supplementary Material. 01(b) to adopt a new provision to exclude "any cash compensation, securities or other benefit received by an associated person, immediate family or affiliate of a participating FINRA member firm if the FINRA member or its parent or other affiliate is issuing its own securities in the public offering."[8] For purposes of this comment submission, the types of offerings described in SIFMA's recommended rule will be referred to as "member offerings."

FINRA declined to propose the provision recommended by SIFMA on the basis that it would represent a broad carve-out that could be used by participating members to circumvent the requirements of the Rule. FINRA stated that, instead, " . . . exemptive relief may be available on a case-by-case basis as necessary . . . ."[9] This response indicates that FINRA does not view the exclusion of persons covered by the definition of "issuer" from the definition of "participating member" as making SIFMA's requested amendment unnecessary. To the contrary, apparently FINRA intends to continue to include in underwriting compensation securities and other payments made in the normal course of business in member offering, thereby raising concerns about the scope of the "issuer" carve-out as previously discussed.

Issues That Arise in Member Offerings: When a FINRA member participates in a member offering, every person related to the issuer and the FINRA member is covered by the definitions of both "issuer" and "participating member." Therefore, absent a specific exemption from underwriting compensation, customary stock grants, cash issuances, and any other intercompany and employee arrangement that involve the receipt of any payment or benefit during the review period is potentially required by current Rule 5110 to be included in underwriting compensation and, if securities, subject to the lock-up restriction.[10]

In my experience, such payments or benefits are in the ordinary course of business and not for the purpose of directing additional underwriting compensation to the FINRA member, particularly when such payments or benefits are only received by persons who are not associated

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[8] Comment letter submitted in response to the FINRA Notice, SIFMA, June 1, 2017 ("SIFMA Comment"), at 21.
[9] SEC Release, at 18610.
[10] The exception proposed in Supplementary Material .01(b)(12) for stock bonus, pension, or profit-sharing plans, discussed *supra,* does not cover all situations of employee compensatory and intercompany arrangements. Moreover, as currently proposed, this provision is likely to continue to require requests for exemptive relief in the case of compensatory plans that are not qualified under Internal Revenue Code Section 401. *See,* further discussion below of this provision.

persons of the FINRA member. Currently, counsel to the underwriters will submit a request for exemptive relief to FINRA staff in these situations to avoid excessive underwriting compensation.

Discussion: FINRA's policy of including, for example, employee stock and cash compensatory plans in underwriting compensation has the potential to disenfranchises persons that should be permitted to receive standard forms of employment compensation despite the fact that the person's employer or the employer's close affiliate is conducting a public offering and is affiliated with a FINRA member.[11] It is an unreasonable burden to require that exemptive relief from the requirements of the Rule be requested in each member offering, thereby delaying the progress of FINRA review.[12]

History of Prior Exception for Securities in Certain Member Offerings: The rules of the National Association of Securities Dealers, Inc. ('NASD"), FINRA's prior name, previously included a provision that excluded certain securities from underwriting compensation in offerings of a FINRA member's securities. Section 14(a) to Schedule E of the NASD Bylaws stated:

> "Notwithstanding the provisions of the 'Interpretation of the Board of Governors -- Review of Corporate Financing' relating to factors to be taken into consideration in determining underwriter's compensation, the value of securities of a new corporate member succeeding to a previously established partnership or sole proprietorship member acquired by such member or person associated therewith, or created as a result of such reorganization, shall not be taken into consideration in determining such compensation."[13]

Schedule E was renumbered as NASD Rule 2720 in approximate 1994. In 2009, the member offering exception was deleted without discussion when FINRA replaced most of the text of that rule[14] and Rule 2790 was subsequently incorporated into the FINRA rulebook as FINRA Rule 5121.[15]

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[11] For similar reasons, FINRA Rule 5130(d)(1)(B) includes an exception permitting certain otherwise restricted broker/dealer personnel to purchase securities in a public offering when the person is an employee or director of the issuer of the issuer, the issuer's parent, or a subsidiary of the issuer or the issuer's parent. However, a similar member offering exception in Rule 5110 would need to also cover persons employed by non-member affiliates of the issuer because of the broad reach of Rule 5110 to compensation acquired by any person employed by an affiliate of the issuer as well as by the affiliated entity of a participating member.

[12] Moreover, the absence of a specific member offering exception from underwriting compensation inserts unnecessary uncertainty into whether the affiliated FINRA member may have to withdraw from underwriting its close affiliate's securities in the event the inclusion of employee compensation or another ordinary-business arrangement would result in excessive underwriting compensation.

[13] NASD Manual, CCH (March 1990, at 1617.

[14] SEC Release No. 34-60113 (June 15, 2009), 74 Fed. Reg. 29255 (June 19, 2009). *See also* FINRA Regulatory Notices 06-52 (September 2006) and 09-49 (August 2009).

[15] SEC Release No. 34-62702 (August 12, 2010); 75 Fed. Reg. 51147 (August 18, 2010).

Recommendation: This is to respectfully request that FINRA reconsider a version of SIFMA's proposal to include a member offering exclusion in Supplementary Material .01(b) that would apply in those circumstances that do not present an opportunity for circumvention of the underwriting compensation restriction of Rule 5110. Following is an example of such an exclusion for:

> any securities or other benefit received or to be received by an associated person, employee or director, or the immediate family of such person, of a FINRA member and any affiliate of such FINRA member if the FINRA member is participating in an offering of its own securities or securities of the FINRA member's direct or indirect holding company or its subsidiary or sister-subsidiary and the securities or other benefit is acquired in the normal course of the business of the company or the person's employment.[16]

The Proposal to Include Securities Purchased from the Public Offering in Underwriting Compensation Should be Withdrawn – Proposed Rule 5110(j)(20)

Introduction – The Proposal: As previously stated, I am opposed to FINRA's proposal to expand the scope of the Rule to, for the first time, require the filing of information regarding and inclusion in underwriting compensation of securities to be purchased from the public offering by a "participating member" unless the purchaser is covered by the definition of "issuer."[17] The FINRA lock-up restriction would be applicable to any such securities that FINRA deems to be underwriting compensation.

The proposed expansion of the scope of Rule 5110 is the result of FINRA's proposal to define the "review period" in proposed Rule 5110(j)(20) to include the distribution of the issuer's public offering.[18] For purposes of this comment submission, this proposed rule change is referred to as the "Public Offering Proposal." FINRA is proposing that the "review period" would begin 180 days prior to the required filing date and continue until the end of 60 days following the effective date or the final closing.

In comparison, although not specifically defined, a pre-offering review period under the current Rule begins 180 days prior to the required filing date and ends on the date of effectiveness or commencement of sales. Then a post-offering review period commences upon completion of the public offering for 90 days. This narrower scope of current Rule 5110 is reflected in Rules 5110(d)(1) and (2), which respectively apply to "Pre-Offering Compensation" and "Post-Offering Compensation."

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[16] The provision will need to also exempt securities purchased from the public offering if the definition of "review period" is not amended as proposed herein.
[17] *See* comments on the two definitions, SEC Release, at 18615, as discussed *supra*.
[18] Neither the FINRA Notice nor the SEC Release include an explanation that the "review period" is proposed to be expanded to include the public offering.

The scope of the definition of "review period" proposed in the FINRA Notice apparently led FINRA to now propose Supplementary Material .04 to establish a principles-based approach for FINRA staff to determine whether securities purchased by a "participating member" from the issuer's directed sales program ("DSP) should be included in underwriting compensation. FINRA stated in the SEC Release that even though the proposed definition of "participating member" would exclude the "issuer:"

> ". . . associated persons and their immediate family members may have [other][19] relationships with issuers that motivate the issuer to sell these persons shares in directed sales programs. These acquisitions may be unrelated to the investment banking services provided by the participating member. To address these situations, under the proposed rule change FINRA would take a principles-based approach to considering whether an acquisition of securities by a participating member pursuant to an issuer's directed sales program may be excluded from underwriting compensation."

Historically, Rule 5110 has never been applicable to securities purchased from the public offering since the original version thereof was adopted in 1970 as the "Interpretation of the Board of Governors – Review of Corporate Financing," Article III, Section 1, NASD Rules of Fair Practice. Moreover, FINRA has not previously expressed concern, and does not now state in the SEC Release, that it has found that "participating members" are making DSP purchases for the purpose of circumventing the underwriting compensation limitations.

Discussion: The extension of FINRA's underwriting review to shares purchased from the public offering would impose an unreasonable burden on FINRA members because it is unnecessary, inappropriate, unnecessary, and in sharp contrast to the intended benefits of the rest of the Proposal for the following reasons.

The Public Offering Proposal is unnecessary because any DSP purchase by a participating member is likely in any event to be excluded from underwriting compensation under the criteria in Supplementary Material .04 by FINRA staff. Thus, I believe that DSP , purchases will be made at the public offering price ("POP") (or net of the underwriting discount) and on the same terms as other DSP offerees (because that is how DSPs are structured), and the purchaser will have a pre-existing relationship with the issuer that justifies the purchase for the reasons further described below.

Further, the Public Offering Proposal is inappropriate because DSP purchases by a person within the definition of "participating member" do not present regulatory issues that are appropriate for regulation by the underwriting compensation provisions of FINRA Rule 5110. Finally, the Public Offering Proposal is both unnecessary and inappropriate because DSP purchases must comply with SEC Regulation M and FINRA Rule 5130, as further described below, which regulations are specifically directed to preventing problematic purchases from a public offering (not just the DSP) and result in such purchases being infrequent.

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[19] This insertion is to clarify that I believe FINRA only intended to refer to purchases by persons who are not included in the definition of "issuer."

The Structure of a DSP: In my experience, all DSPs offer the same terms to all eligible purchasers from the DSP. Thus, the situation should not arise that the participating member purchaser will be afforded the opportunity to acquire securities from the DSP on different terms than other eligible offerees, except to the extent that the purchased shares may be subject to a restriction on resale as are the securities of certain of the other DSP purchasers.

With respect to the purchase price of DSP securities, DSPs have been under enhanced scrutiny by the SEC and the SEC-registered national stock exchanges for many years. Both such regulators have expressed concerns in their review of proposed public offerings that company "insiders" should not have the ability purchase securities from the company's public offering at a significant discount to the POP. Therefore, as a matter of long practice and such regulatory concerns, issuer DSP securities are, most often, offered at the POP. Infrequently, the DSP shares are offered net of the underwriting discount (usually, no more than 7%) when the issuer determines to not compensate the underwriters for sales of DSP securities. The determination by the issuer to sell DSP securities net of the discount is not requested by and contrary to the interests of the underwriters. For these reasons, DSP securities will have no or very little possible compensation value for purposes of Rule 5110 and any discount is at the request of the issuer.

Other Regulations Apply to Purchases by Participating Members from the Public Offering: Other federal regulations obviate the need for regulation by Rule 5110 because they: (1) limit the occurrence of such purchases to those with a reasonable justification for the purchase; and (2) will usually require that the FINRA-related purchasers not sell such securities for several months after the public offering in order to demonstrate required investment intent.

The *Bona Fide* Public Offering Obligation: FINRA members participating in a public offering must comply with SEC Regulation M and FINRA Rule 5130, which have the general purpose of obligating participating members to make a *bona fide* public offering, as is also contractually required by the underwriting agreement between the issuer and the underwriters. To be *bona fide*, sales of a public offering must be made to the investing public, unless circumstances exist which justify and permit the purchase.

SEC Regulation M Requirements: SEC Regulation M imposes a stringent anti-manipulation requirement that a "distribution participant"[20] must sell a distribution of securities to *bona fide* public investors. To achieve this purpose, SEC Regulation M would designate persons within FINRA's definition of "participating member" as an "affiliated purchaser"[21] of a "distribution

[20] *See,* definition of "distribution participant" in Rule 100(b) of Regulation M.
[21] *See,* definition of "affiliated purchaser" in Rule 100(b) of Regulation M.

participant" who may not purchase from the offering unless the person acquires the securities for investment." Investment intent is demonstrated by the affiliated purchaser holding the securities for a significant period of time. Although Regulation M does not impose a specific holding period, due to the requirements of SEC Rule 144, the holding period is usually six months in the case of an initial public offering ("IPO").

The practical effect of Regulation M is that FINRA members that participate in public offers are required by FINRA rules to have policies to prohibit purchases by associated persons of the FINRA member and employees of affiliates unless the transaction is justified by a pre-existing relationship between the purchaser and the issuer in order to comply with SEC Regulation M. Thus, FINRA members' internal policies will limit the circumstances under which a person within the definition of "participating member" would purchase securities from a public offering.

FINRA Rule 5130 Requirements: In addition, FINRA members must comply with FINRA Rule 5130 in the case of a "new issue"[22] of securities. Rule 5130 prohibits any FINRA member participating in a public offering of a "new issue" from sales of the securities to a "restricted person."[23] That term is defined to include the personnel of any broker/dealer regardless of whether participating in the public offering, their immediate family members, finders and fiduciaries to the managing underwriter, and certain direct and indirect owners of a broker/dealer and can reach a subsidiary and sister-subsidiary of a broker/dealer (and the employees thereof).[24] These restricted persons who are related to a FINRA member participating in a public offering would be included in FINRA's proposed definition of "participating member."

Although Rule 5130 contains certain exemptions that could allow a person within the definition of "participating member" to purchase public offering securities in the case of a "new issue," these exemptions operate in such limited circumstances that they do not present a potential to be used to circumvent the underwriting compensation limitations of Rule 5110.

Recommendation: This is to recommend that FINRA withdraw proposed Supplementary Material .04 and amend the proposed definition of "review period" in proposed Rule 5110(J)(20) to be consistent with the current Rule by amending sub-provisions (A), (B) and (C). Since each of these provisions applies to a different offering structure, following is the relevant text of sub-provision (A) that would be amended as follows:[25]

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[22] Rule 5130(i)(9) defines "new issue."

[23] Rule 5130(i)(10) defines "restricted person."

[24] *See,* explanation of Rule 5130, when the rule was significantly revised and renumbered as NASD Rule 2790, in. Rothwell, *The NASD Revises Its Regulation of IPO Sales,* Insights, Aspen Publishing, Volume 18, No. 1, January 2004, at 8 *et seq.*

[25] Proposed deletions are in brackets and proposed additions are underlined in this comment submission..

> . . . the 180-day period preceding the required filing date of the public offering until the date of effectiveness or commencement of sales of the public offering [through] and the 60-day period following the effective date of the offering;

The Proposed Expansion of the Seasoned Issuer Filing Exemption to any Public Offering When the Issuer has Securities of the Same Series as Investment Grade Rated Securities Should be Withdrawn – Proposed Rule 5110(h)(1)(A)

Introduction: FINRA is proposing to amend the filing exemption provided under current Rule 5110(b)(7)(A), to be renumbered Rule 5110(h)(1)(A), to extend the filing exemption to securities in the same series that have equal rights as investment grade rated securities as follows:

> securities offered by a [corporate] bank, corporate issuer, foreign government or foreign government agency [issuer which] that has unsecured non-convertible debt with a term of issue of at least four [(4)] years[,] or unsecured non-convertible preferred securities[,] that are investment grade rated [by a nationally recognized statistical rating organization in one of its four (4) highest generic rating categories], as defined in Rule 5121(f)(8), or are securities in the same series that have equal rights and obligations as investment grade rated securities, provided [except] that an [the] initial public offering of [the] equity [of an issuer] is required to be filed;

Discussion: Proposed Rule 5110(h)(1)(A) is known as the "seasoned issuer filing exemption" because the exemption is available to any offering of equity or debt securities by an issuer that qualifies on the basis of having outstanding investment grade rated non-convertible debt or non-convertible preferred securities with a term of issue of at least four years.[26] The seasoned issuer filing exemption should be distinguished from the filing exemption for an offering of only investment grade rated non-convertible debt or non-convertible preferred securities (which need not have a term of issue of at least four years) in proposed Rule 5110(h)(1)(B), which is known as the "investment grade offering filing exemption."

I am opposed to the proposed extension of the seasoned issuer filing exemption to an issuer's public offerings where the issuer has "securities in the same series that have equal rights and obligations as investment grade rated securities" on the basis that the change would be

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[26]"All debt and equity offerings of securities offered by a corporate, foreign government, or foreign government agency issuer which has senior non-convertible debt or preferred securities rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories, will be exempt from the filing requirements. . . . . If an issuer has such a rating on its senior non-convertible debt or preferred equity securities, then any offering of debt or equity securities by that issuer would be exempt from the filing requirements." NASD Notice to Members 85-6. In 1986, NASD adopted further amendments to the exemption requiring the referenced debt securities to have a term of four years. NASD referred to " . . . the current exemption for debt and equity offerings of corporate issuers that have non-convertible debt or preferred securities rated investment grade . . . ." in NASD Notice to Members 86-27.

inconsistent with the investor protections provided when the issuer has current investment grade rated qualifying securities outstanding at the time of the offering.[27] While the practical operation of the proposed amendment is somewhat unclear, I am concerned that the proposed amendment would allow an issuer to avoid filing a public offering of any type of securities with FINRA for review of compliance with Rule 5110 based on the issuer only having outstanding unrated non-convertible debt or preferred securities that the issuer deems to be in the same series as qualifying reacquired treasury securities that were once rated investment grade. The fact that a prior issue of qualifying debt or preferred securities received an investment grade rating does not mean that the issuer's current outstand debt or preferred securities would receive such a rating, which is the investor protection basis for the seasoned issuer filing exemption.

Recommendation: Therefore, this is to recommend that FINRA withdraw the proposed expansion of the seasoned issuer filing exemption to "securities of the same series."

The Seasoned Issuer Filing Exemption Requirement that the Issuer Must Have Qualifying Investment Grade Rated Securities Should be Clarified -- Rule 5110(h)(1)(A)

Discussion: I understand that from time-to-time FINRA has received an inquiry as to whether the issuer's qualifying debt or preferred securities for purposes of the seasoned issuer filing exemption in proposed Rule 5110(h)(1)(A) must be issued and outstanding, which would exclude the issuer's reacquired treasury securities. Form these inquiries, it appears that the exemption text is unclear because the text only states that the filing exemption is available when the issuer "has" qualifying investment grade rated securities. I believe the inquiries result from the fact that reacquired treasury securities may technically qualify under that standard.

Recommendation: Therefore, this is to recommend that FINRA amend proposed Rule 5110(h)(1)(A) to add the word "outstanding" after the word "has" to ensure that it is clear that an offering of debt or equity securities can only rely on the seasoned issuer filing exemption at a time when the issuer "has outstanding" a qualifying issue of investment grade rated debt or preferred securities so that treasury securities cannot be thought to qualify for this purpose.

[27] The proposed amendment may be based on the investment grade securities exemption to the requirement for a qualified independent underwriter ("QIU") in FINRA Rule 5121(a)(2)(1)(C). This QIU exemption is only available if the offering of securities is of investment grade rated debt or are debt securities in the same series with equal rights and obligations as a prior issue of investment grade rated debt (which prior issue may or may not be currently outstanding). Thus, the QIU exemption structure in Rule 5121 does not provide an appropriate rationale for the proposed amendment to the seasoned issuer filing exemption in Rule 5110.

The Method for Valuing Unit Securities Should be Clarified and Revised – Proposed Rule 5110(c)

Introduction: In the SEC Release, FINRA addressed the comment I submitted in response to the FINRA Notice, where I requested that a unit security (composed of common stock and a warrant for common stock) that is treated as underwriting compensation (referred to herein as a "compensation unit") for which the purchaser pays the same price as the public for public offering units should be valued in the same manner as a non-convertible security.[28] My view was that the compensation units should have a zero value since they were purchased at the same price that the public will pay for the offering units.[29] Thus, FINRA should not (as is the current practice) ascribe a compensation value to the warrant within the unit.

FINRA responded to my comment in the SEC Release, stating that its prior guidance in NASD Notice to Members 92-28 (May 1992) ("Notice 92-28") included examples for the valuation of compensation units and did not make the recommended change because of concerns that the warrant in the compensation unit may have terms different than those in the public units.[30]

Discussion: This is to respectfully request that FINRA reconsider my comment, taking into account the following additional information that may be helpful in reaching a different conclusion with respect to the valuation of certain compensation units and otherwise clarifying the valuation method to be used.

My objection to relying on the guidance in Notice 92-28 is based on the fact that the valuation method in the Notice does not result in an accurate valuation of compensation units because it does not deduct the purchase price as is required by by current Rule 5110(e)((3) and proposed Rule 5110(c)(3) (known as the "Warrant Formula"). This problem in the guidance is because the guidance in Notice 92-28 was intended to address a different situation than compensation units. The arrangement that is covered by the guidance is where the issuer grants a participating member an option or warrant to be exercised at some time after the public offering for a unit composed of common stock and a warrant for common. In this situation, the participating member does not purchase the warrants except, perhaps, for pennies; hence the concept of "penny warrants."

As a result of the absence of a deduction for the purchase price, the valuation guidance in Notice 92-28 results in an excessive valuation for the common stock in compensation units, which is then added to a separate valuation of the common stock underlying the warrant in the compensation units. In comparison, the valuation ascribed to paid-for compensation units by entering the relevant information into FINRA's Public Offering System takes into account the purchase price, which results in a zero value for the common stock in the compensation units

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[28] Comment letter submitted in response to FINRA Notice by Rothwell Consulting, June 27, 2017 ("Rothwell Comment"), at 7-8.
[29] My proposal was made only with respect to situations where the compensation and public offering units would have the same or similar terms.
[30] SEC Release, at 18617.

when the POP is paid, even though it also ascribes a separate value to the warrants. Fortunately, FINRA staff generally rely on the compensation value ascribed to compensation units by the FINRA Public Offering System.

Recommendations: In order to address unit valuations when differences exist between terms of the warrants within compensation units and the public offering units, as discussed by FINRA in the Proposal, this is to recommend that FINRA provide guidance on the valuation of compensation units either in a supplement to Rule 5110 or in the FINRA Regulatory Notice announcing adoption of the rule change that conforms with the valuation method applied by FINRA's Public Offering System. I believe that the method in such situations is the following:

1. The common stock in the compensation units and the common stock underlying the warrant in the compensation units are valued separately and then added together.
2. The common stock within the compensation units are valued pursuant to proposed Rule 5110(c)(2) as the difference between the POP and the price paid for the compensation unit, *i.e.,* the compensation unit purchase price is ascribed solely to the common stock in the unit.
3. The common stock underlying the warrant within the compensation unit is valued using the method in Notice 92-28. If the value of the common stock underlying the warrant does not meet the warrant *de minimis* test in proposed Rule 5110(c)(3)(H), the *de minimis* value of such securities is calculated.
4. The two valuations are added together as a percentage of the proposed "offering proceeds," as defined in proposed Rule 5110(j)(13).

This is also to respectfully recommend that FINRA adopt an exception to the unit compensation valuation method described above so that compensation units will be ascribed a zero valuation in the situation when the compensation units are:

1. purchased at the same price as the POP;
2. the warrants in the compensation units are not exerciseable for more securities than the public warrants; and
3. the terms of the compensation unit warrants are not better than those of the public warrants.[31]

The Warrant Formula was originally intended to address situations where the issuer granted warrants for common stock to the underwriter generally for no payment and the public offering is solely composed of common stock. The Warrant Formula provides a reasonable estimate of the potential future value of the common stock underlying the warrants in such situations where the public does not have an equal future right to exercise issuer warrants for additional common stock.

[31] The terms of the warrants in the compensation units are often more restrictive than those of the warrants in the public units in order for the participating member to comply with the warrant term restrictions in proposed FINRA Rule 5110(g)(8) or for other reasons that benefit the issuer. Moreover, there are circumstances where the issuer will negotiate that the compensation units include warrants that are exercisable for fewer shares of common stock than the public offering warrants, which clearly benefits the issuer and public investors.

In comparison, in the limited situation covered by the proposed exception, the issuer is raising raising capital both from investors and a participating member in two stages. By selling units to a participating member at the POP, the issuer is raising pre-offering capital that benefits public investors and anticipates it will raise further capital when the participating member purchaser exercises the warrants (which would occur when the public is exercising their warrants).[32] Thus, the participating member purchaser is investing in the issuer along side its customers, which has been an objective of numbers of securities regulation professionals wihin the SEC.

For these reasons, I believe that in the limited situation proposed above FINRA should not assign the warrants in the compensation units an additional and effectively redundant valuation (including a *de miminis* valuation), with the result that such compensation units will be assigned a zero valuation.

The Definition of "Experienced Issuer" Should be Revised to Explain "Reporting History" – Proposed Rule 5110(j)(6)

This is to recommend that FINRA revise the proposed definition of "experienced issuer: in Proposed Rule 5110(j)(6) to explain the requirements that must be met to satisfy the "reporting history" requirement, since this term is not defined elsewhere in Rule 5110. For example, the term might be defined as a company that has consistently filed the periodic reports required to be filed with the SEC under the Securities Exchange Act of 1934 for a period of at least 36 months.

The Definition of "Independent Financial Adviser" Should be Clarified and Expanded – Proposed Rule 5110(j)(9)

Introduction: FINRA is proposing to move the criteria for a participating member to qualify for the "independent financial adviser" exception to being deemed to be "participating" in a public offering to a stand-alone definition proposed in Rule 5110(j)(9). The criteria would continue to require that the independent financial adviser cannot be "engaged in, nor affiliated or associated with any entity that is engaged in, the solicitation or distribution of the offering."

Discussion: In reviewing the background of this exception, I believe that FINRA intended that an independent financial adviser would only be excluded from that part of the definition of "participation" that covers "providing advisory or consulting services to the issuer related to the offering."[33] Thus, I believe FINRA would consider an ostensible independent

[32] The participating member is likely to exercise its warrants at same the time that public investors are also exercising their warrants because the warrants are "in the money." Therefore, the participating member's warrant exercise will not have a disproportionate impact on the public market in the common stock of the issuer.
[33] "However, also included within the definition of 'participating in a public offering' is participation in 'any advisory or consulting capacity related to the offering.' Unlike in cases where a member is involved in distribution

financial advisor to be a "participating member" if the advisor engaged in any of the other activities that constitute "participation" in the offering, including:

> "the preparation of the offering document or other documents, . . . [and] furnishing of customer or broker lists for solicitation . . . ."[34]

I am concerned that an adviser may mistakenly believe that it is permissible to provide a customer list for solicitation because this activity is not clearly a "solicitation or distribution of the public offering." Moreover, the prohibition on the adviser assisting in the preparation of offering documents is rather awkward since: (1) the role of the adviser is to provide its expertise to the issuer in preparing for the public offering; and (2) it is the issuer's staff, counsel and advisers that prepare the offering and other related documents. I believe that FINRA should extend the independent financial adviser exception to allow an adviser to provide such ordinary services to the issuer.

Recommendation: This is to respectfully recommend that FINRA revise proposed Rules 5110(j)((9) and (16) to clarify that an independent financial adviser may not engage in any other of the activities described in the definition of "participation" except for providing advisory or consulting services to the issuer and assisting the issuer in the preparation of the offering document or other documents.[35] FINRA may wish to consider the following revisions to accomplish this purpose.

> **Rule 5110(j)(16) * * ***
>
> (B) [advisory or consulting] services provided to the issuer by an independent financial adviser, provided that another member or members are participating in the offering.
>
> **Rule 5510(j)(9)**
>
> The term "independent financial adviser" means a member or a person affiliated or associated with a member that provides advisory or consulting services to the issuer <u>that may include involvement in the preparation of the offering document or other documents</u>[and]<u>; provided that such adviser</u> is neither engaged in, nor affiliated or associated with any entity that is engaged in, the solicitation or distribution of the offering <u>as such activities are described in Rule 5110(j)(16).</u>

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and solicitation activities, a member that solely provides advisory or consulting services typically would not have a significant degree of leverage over an issuer. Consequently, FINRA does not believe that the harms sought to be prevented by Rule 5110 are likely to occur in such cases." SEC Release No. 34-71372 (Jan. 23, 2014); 79 Fed. Reg 4793 (Jan. 29, 2014), at 4794.

[34] Proposed FINRA Rule 5110(j)(16).

[35] If FINRA adopts this recommendation, FINRA may wish to remind any FINRA member that acts as an independent financial adviser and assists in the preparation of an issuer's offering document, that the offering document may be deemed a communication by the member with the public, which would subject the document to the "fair and balanced" and any other applicable standard of FINRA Rule 2010 (Communications With the Public). Such advice would be consistent with FINRA Regulatory Notice 10-22 (April 2010).

The Definition of "Participate" Should be Further Clarified – Proposed Rule 5110(j)(16)

FINRA proposes to amend the text of proposed Rule 5110(g)(11) to clarify the types of impermissible activities by unregistered persons to include "solicitation, marketing, distribution or sales of the offering." In comparison, the proposed definition of "participate" in Rule 5110(j)(16) is less clear in that it refers more generally to ". . . involvement in the distribution of the offering . . . ." I recommend that this detail of the types of activities that are considered to be "involvement in the distribution of the offering" be incorporated into the definition of "participate" in proposed Rule 5110(j)(16) to provide additional clarity as follows:

> The terms "participate," "participation" or "participating" in a public offering means involvement in the preparation of the offering document or other documents, involvement in the distribution of the offering <u>(including solicitation, marketing, distribution or sales of the offering)</u>, furnishing of customer or broker lists for solicitation, or providing advisory or consulting services to the issuer related to the offering . . . .

The Explanation of a Plan that is "Similar" to a Section 401 Qualified Plan Should be Further Clarified – Supplementary Material .01(b)(12)

Introduction: FINRA proposed in the FINRA Notice and the Proposal to revise Supplementary Material .01(b)(12) to extend the exclusion from underwriting compensation for securities acquired from any stock bonus, pension, or profit-sharing plan that qualifies under Section 401 of the Internal Revenue Code ("IRC") to a "similar plan." The welcome extension of the exclusion to other compensatory plans by FINRA was intended to avoid having to request exemptive relief from FINRA in the many situations where securities are acquired by a person within the definition of "participating member" pursuant to a plan that was not formed pursuant to IRC Section 401.

FINRA stated in the SEC Release that I and certain other commenters on this specific proposal had ". . . suggested amending proposed Supplementary Material .01(b)(12) to Rule 5110 to expressly provide that securities received by directors or employees under any written compensatory benefit plan would not be underwriting compensation."[36] The revision I recommended proposed to extend the exclusion ". . . as determinded on a case-by-cse basis, [to] compensation received through any other type of written plan that was initially established in the ordinary course of business."[37] FINRA responded to my proposal and the other commenters by stating that, instead:

> "FINRA would interpret the reference to a 'similar plan' . . . to include a written compensatory benefit plan for directors and employees that provides for comparable grants of securities to similarly situated persons (*e.g.,* a written compensatory benefit plan that provides comparable grants of securities to all qualifying employees) and

[36] SEC Release, at 18610.
[37] Rothwell Comment, at 11.

> accordingly does not propose to change the Rule text. A 'similar plan' would not include a compensatory benefit plan that was developed or structured to circumvent the requirements of Rule 5110."[38]

Discussion: This is to respectfully request that FINRA reconsider its response in light of the following discussion.

I am concerned, although it may not have been intended, that this explanation means that FINRA may require that a "similar plan" must be made available to all of the issuer's directors and employee or to all directors or all employees. Moreover, the response raises the possibility that FINRA staff may require that a qualifying plan meet certain of the other requirements that are necessary if the plan sought to qualify as an IRC Section 401 plan.[39] As I explained in my comment on the FINRA Notice:

> "A private company is less likely than a public company to have an employee plan that complies with IRC Section 401. Instead, a private company is likely to establish a plan that provides stock compensation, bonuses and incentives to the company's more highly compensated officers and directors in order to attract qualified management and directors to the company. Therefore, the securities to be awarded under such non-tax qualified stock compensation, bonus, and incentive plans do not receive favorable tax treatment under the IRC."[40]

I agree with FINRA's over-all policy position that the expanded exclusion should only be available to plans that do not comply with IRC Section 401 when the plan is demonstrably established for purposes of usual employee and director compensation and not for purposes of directing additional underwriting compensation to the affiliated participating member. This is to respectfully suggest that FINRA consider that using the word "similar" is misleadingly narrow for this purpose and is likely to result in case-by-case requests for interpretations and exemptive relief in many situations.

Recommendations: This is to recommend that FINRA consider a proposed revision of Supplementary Material .01(b)(12) to replace the words "or a similar plan" with a description that would clarify that another form of compensatory plan will be covered by the exclusion even if it is not provided to all directors and employees as a single group. A proposed amendment to the provision is set forth below. If FINRA continues to prefer to retain the simpler reference to a "similar plan," I recommend that FINRA use a form of the suggested new text as a more detailed explanation of a "similar plan."

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[38] SEC Release, at 18610..
[39] *See,* detailed explanation of Internal Revenue Service requirements for a Section 401 Plan and the different structure of employee plans adopted by private companies in the comment letter submitted in response to the FINRA Notice. Rothwell Comment, at 11.
[40] Rothwell Comment, at 11.

compensation received through any stock bonus, pension, or profit sharing plan ("compensatory plan") that qualifies under Section 401 of the Internal Revenue Code or that is another form of compensatory plan that is made available to all of the issuer's employees or directors or to a definable subset of such groups, so long as such other compensatory plan provides comparable grants of securities to all persons in the group covered by the plan and was established in the ordinary course of business.

* * * *

I appreciate the opportunity to comment on FINRA's significant proposed amendments to the rules regulating underwriting terms and arrangements. If you require further information regarding these comments, please contact the undersigned.

Very truly yours,

Suzanne Rothwell
Managing Member