Stuart J. Kaswell, Esq.

May 17, 2019

Vanessa Countryman
Acting Director
Office of the Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Release No. 34-85715; File No. SR-FINRA-2019-012

Dear Ms. Countryman:

Thank you for the opportunity to comment on FINRA's proposed revisions ("the Proposal") to Rule 5110 (Corporate Financing Rule—Underwriting Terms and Arrangements) (the ''Rule'').[1] I have a fundamental concern with the Proposal and with the underlying Rule itself. I commend FINRA for examining its rules generally to determine if they continue to achieve their intended purposes, and if not, to seek ways to improve them.[2] Without commenting on the specifics of the Proposal, I am confident that FINRA examined the Rule with care, sought input from interested parties, and skillfully sought to make improvements.

My concern lies with the fundamental purpose of the Rule, which is to limit the amount of compensation that a broker-dealer may receive when underwriting a public offering. I raise this concern, not out of some misperception about the need to protect the incomes of broker-dealers, but because of the harm such a rule inevitably causes to economic development.

At first blush, the goal of ensuring that investors' funds go primarily to the issuer seems laudable. The issue is not new. For example, the Securities and Exchange Commission's ("SEC" or the "Commission") 1963 Special Study notes:

> The New York Stock Exchange had shown an interest in the subject of underwriters' compensation as early as 1959, and during 1961 its staff conducted studies looking toward the development of an appropriate policy. The NASD in December 1961 announced that a special committee of its board of governors

[1] 84 FR 18592 (May 1, 2019).
[2] *Id*.

> would review all offerings of unseasoned companies to determine whether the underwriting arrangements were fair and consistent with just and equitable principles of trade under its rules of fair practice. No precise standards were announced by the NASD as to what compensation would be considered "unreasonable" or "unconscionable." It would appear that these determinations were to be made on a case-by-case basis.
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> Simultaneously, the [New York Stock] Exchange called the attention of its membership to the NASD statement and cautioned them about the underwriting of low-priced new issues. In the following month, member firms active in underwriting were informed of the standards that would be used by the Exchange in judging the reasonableness of compensation.
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> It is too early to say whether these measures will be adequate to prevent the abuses prevalent during the past few years. Essentially the matter of underwriters' compensation is one of business ethics, with which the self-regulatory agencies ought to have special concern and the capacity to deal effectively.[3]

The Special Study further noted:

> The NASD has a taken a forward step in providing for the review of underwriting arrangements in connection with offerings of unseasoned companies. To provide guidance to its membership, the NASD should periodically publish summaries of specific rulings relating to the amounts of compensation and types of compensation arrangements that have been considered unacceptable in given circumstances.[4]

I presume that the Rule is the descendant of this discussion, although FINRA has taken the reverse approach of not disclosing the exact amounts of compensation that an underwriter may or may not charge.[5] FINRA cites laudable public policy goals as the basis for the Rule.[6] Over the

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[3] SEC, Report. of the Special Study of the Securities Markets of the Securities and Exchange Commission, 88th Cong. 1st. Sess. H. Doc. No. 95 (1963) Chapter IV, Primary and Secondary Distributions to the Pubic, at 512 (citations omitted).
[4] *Id.* at Part 5, Recommendations at 73.
[5] Rule 5110(c)(2) provides:

> **Amount of Underwriting Compensation**
> (A) No member or person associated with a member shall receive an amount of underwriting compensation in connection with a public offering that is unfair or unreasonable and no member or person associated with a member shall underwrite or participate in a public offering of securities if the underwriting compensation in connection with the public offering is unfair or unreasonable.

[6] FINRA notes:

> The ability of small and large businesses to raise capital efficiently is critical to job creation and economic growth. Since its adoption in 1992 in response to persistent problems with underwriters dealing unfairly with issuers, Rule 5110 has played an important role in the capital raising process by prohibiting unfair underwriting terms and arrangements in connection with the public offering of securities. Moreover, Rule 5110 continues to be important to ensuring investor protection and market integrity through effective and efficient regulation.

years, FINRA has had to interpret and modify the rule as market practices evolved to ensure meaningful compliance, without extending the scope of the rule beyond its intended purpose.

However laudable the goal of the Rule and FINRA's efforts to administer it, the fundamental purpose of the Rule is to regulate prices. An issuer seeking to sell shares to the public by means of an underwriter will negotiate with one (or more) broker-dealers in search of the lowest price. A broker-dealer might be willing to underwrite the shares of a new issuer, but may seek high compensation because of the attendant commercial and legal risks. The Rule prevents the issuer and the underwriter from agreeing to compensation at a price that the Rule and FINRA staff determine to be unfair or unreasonable.

Regulators with good intentions have sought to impose price controls throughout history with the same outcome – disruption of economic activity, shortages, and sometimes economic "cheating" *i.e.*., "black markets."[7] Then-Fed Chairman Ben Bernanke stated that price controls on oil were a major cause of gas lines in the U.S. during the Arab Oil Embargo in the early 1970s. "As basic economics predicts, when a scarce resource cannot be allocated by market-determined prices, it will be allocated some other way--in this case, in what was to become an iconic symbol of the times, by long lines at gasoline stations."

We don't have long lines of would-be issuers outside of underwriters. Instead, the Rule forces those would-be issuers to seek financing elsewhere.[8] Some may succeed; others may not.[9]

FINRA's role to protect the public from excessive underwriter's compensation then serves as a check or "gatekeeper" on the capital raising process in the U.S. I appreciate that when Congress enacted the Maloney Act in 1938[10], it contemplated that a self-regulatory organization ("SRO") would set standards for broker-dealers above the basic antifraud standards that the SEC establishes. FINRA's hallmark has been to establish "just and equitable principles of trade," for its members to protect investors. But in 1975 Congress specifically deleted from Section 15A of the Exchange Act a requirement that a registered securities association must "provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges."[11]

Proposal at 84 FR 118592.

7 Chairman Ben S. Bernanke, Remarks on Class Day, Harvard University, June 4, 2008, available at https://www.federalreserve.gov/newsevents/speech/bernanke20080604a.htm. *Cf.* Congress established a $10 limit on legal fees for veterans seeking government pensions after the Civil War. Congress sought to protect veterans from unscrupulous lawyers who would take most of the pension money for themselves. Congress left the limit in place for over 120 years, effectively denying veterans the right to counsel in disability cases. *Walters v. Radiation Survivors,* 473 US 305 (1985), (dissent, Justice Stevens).

8 I am not suggesting that there never can be a public policy justification for price regulation. Nonetheless, I believe that the economic harm of price regulation is formidable and that such restrictions are difficult to justify.

9 The SEC and its staff have expressed concern about issuers reluctance to raise money in the public markets. *E.g.,* Remarks of William Hinman, Director, Division of Corporation Finance, SEC, Keynote Address at the PLI's Seventeenth Annual Institute on Securities Regulation in Europe, Feb. 1, 2018, available at https://www.sec.gov/news/speech/speech-hinman-020118.

10 http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1930/1938_0625_MaloneyAct.pdf

11 The following compares the original version of the Maloney Act with the 1975 revision:

Moreover, in 1996, Congress enacted the National Securities Markets Improvements Act. Among other changes, Congress amended Section 3 of the Securities Exchange Act of 1934 ("Exchange Act") to provide that:

> (f) CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION.—Whenever pursuant to this title the Commission is engaged in rulemaking, or **in the review of a rule of a self-regulatory organization**, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. [**Emphasis added**][12]

Finally, and perhaps most importantly, when Congress enacted the Securities Act, it relied on the disclosure model of regulation, not merit review.[13] Congress did not establish the SEC to pass

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~~"(7) the~~ (6) The rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to ~~provide safeguards against~~foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members, or to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the association. ~~unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges;~~

[12] Pub. L. No 104-290, Oct. 11, 1996, 110 Stat. 3425. NSMIA added similar language, omitting the SRO language, to the Securities Act of 1933 ("Securities Act"), the Investment Company Act of 1940, and the Investment Adviser Act of 1940.

[13] *Cf.* Brandeis, Other People's Money, Chapter V, (1913), available at https://louisville.edu/law/library/special-collections/the-louis-d.-brandeis-collection/other-peoples-money-chapter-v. Future Justice Brandeis noted:

> But the disclosure must be real. And it must be a disclosure to the investor. It will not suffice to require merely the filing of a statement of facts with the Commissioner of Corporations or with a score of other officials, federal and state. That would be almost as ineffective as if the Pure Food Law required a manufacturer merely to deposit with the Department a statement of ingredients, instead of requiring the label to tell the story. Nor would the filing of a full statement with the Stock Exchange, if incorporated, as provided by the Pujo Committee bill, be adequate.
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> To be effective, knowledge of the facts must be actually brought home to the investor, and this can best be done by requiring the facts to be stated in good, large type in every notice, circular, letter and advertisement inviting the investor to purchase.

By comparison, FINRA Rule 5110(b)(3) provides that "FINRA shall accord confidential treatment to all documents and information filed pursuant to this Rule and shall utilize such documents and information solely for the purpose of review to determine compliance with the provisions of applicable FINRA rules or for other regulatory purposes deemed appropriate by FINRA."

on the merits of an offering, and of course, it is a criminal violation to suggest otherwise.[14] By placing the Rule as an impediment to a pubic offering, FINRA is acting in a manner analogous to a merit regulator – determining on a subjective basis whether the underwriter's compensation is excessive. Although somewhat different from a state merit review, which typically goes to the state administrator's view of the viability of the issuer and its business plan, the Rule presents a similar barrier to offering securities to the public. FINRA notes that:

> FINRA does not approve or disapprove an offering; rather, the review relates solely to the FINRA rules governing underwriting terms and arrangements and does not purport to express any determination of compliance with any federal or state laws, or other regulatory or self-regulatory requirements regarding the offering. A member may proceed with a public offering only if FINRA has provided an opinion that it has no objection to the proposed underwriting terms and arrangements.[15]

If FINRA determines that an underwriter's compensation is too rich, the would-be issuer is foreclosed from the public securities markets. Although limited to underwriter's compensation, such gatekeeping is inconsistent with the disclosure-based model that is the defining characteristic of the Securities Act.

I do not believe that it is possible to reconcile the Rule with the express statutory requirements of the Exchange Act and the overall framework of the Securities Act. As a general matter, the federal courts have construed the Securities Act and the Exchange Act *in pari materia*.[16] It would be inconsistent with this framework to permit a FINRA rule to compromise the basic statutory purpose of the Securities Act.

The Proposal states FINRA's belief that "the Proposal does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. All members would be subject to the proposed amendments."[17] I respectfully disagree with statement. As noted above, I do not believe that the rule is consistent with Sections 15A and 3(f) of the Exchange Act. Moreover, I do not believe that the Commission should consider the competitive effects of the Proposal purely with respect to broker-dealers. Of course, the Proposal applies to all broker-dealers that are FINRA members; the more important analysis is whether the Proposal presents limitations on businesses and their ability to raise capital. In my view, the Proposal and the Rule impose burdens on competition that are not consistent with the Exchange Act and are inconsistent with the purposes of the Securities Act.

The Proposal also states that FINRA has considered the regulatory need for the Proposal and concluded that these changes are justified. As noted, I presume that FINRA has take great care to suggest changes to the Rule that would make it operate more efficiently. But as also noted, I do not agree with the basic thrust of the Rule and therefore do not believe that fine tuning it would address these concerns. The Rule, even with improvements, will continue to impose substantial costs on broker-dealers and issuers, including the ultimate cost of preventing some

[14] *E.g.*, 17 CFR §229.501(b)(7).
[15] Proposal at n. 4.
[16] Tcherepnin v. Knight, 389 U.S. 332 (1967).
[17] 84 FR at 18601.

issuers and broker-dealers from making public offerings. The Proposal alone is 618 pages. I do not believe that FINRA has met its burden of explaining that the changes meet the standard of Section 3(f) of the Exchange Act.

Instead of limiting underwriter's compensation, FINRA and Commission should address the concern about excessive compensation in the same way that Securities Act addresses other concerns: by disclosure. When Congress enacted the Securities Act, it trusted investors to make their own decisions, provided that they had all of the material information necessary. The Securities Act expresses Congress's confidence in a public investor's ability to evaluate the business proposition of any type of issuer, regardless of the nature of the business or the risks involved. I do not believe that there is any policy justification to warrant taking an evaluation of the underwriter's compensation out of the investor's hands. For example, Item 501(b)(3) of Regulation S-K requires the registration statement to disclose the underwriter's discounts and commissions, the net proceeds [the issuer] receive[s], and any selling shareholder's net proceeds. Perhaps FINRA could share its expertise with the Commission to augment the issuer's disclosure of compensation.

Accordingly, I respectfully suggest that FINRA should withdraw the Proposal and reconsider the Rule in its entirety. If FINRA disagrees with that suggestion, I urge the Commission to institute proceedings to determine whether it should approve or disapprove the Proposal. Finally, I suggest that should FINRA remain steadfast in its support of the Rule, that the Commission should consider instituting proceedings under Section 19(c) of the Exchange Act to delete the Rule in its entirety. In addition, I suggest that the Commission work with FINRA and all interested parties to ensure that an issuer making a public offering discloses all material information relative to the underwriter's compensation and that the issuer makes that information available to investors consistent with the current practice for all other information.

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These views are my own and do not represent the view of any other person or entity. I would be pleased to discuss my suggestions with the Commission or the staff in greater detail.

Sincerely,

/s/

Stuart J. Kaswell

Copy: Robert Colby, CLO, FINRA