NETWORK 1 FINANCIAL
SECURITIES, INC.

10 March 2011

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, D.C. 20006-1506

Re: Comment on Regulatory Notice 11-04
(relating to Proposed Rule regulating Private Placement of Securities)

Dear Ms. Asquith:

Network 1 Financial Securities[1] greatly appreciates FINRA's general invitation to the membership to comment on the proposed rule change to existing FINRA Rule 5122. Accordingly, we are please to take this opportunity to comment on the changed being proposed.

1. **Revised Rule 5122 Must Demonstrate Understanding of the Essential Business Purpose that Private Placements Serve in Capital Formation for the Small Business Owner:**

President Barrack Obama recently stated:

> *So America's small business owners -- people like Dave Sullivan* [a small business owner seeking financing and mentioned earlier in the President's address] -- *have always been the backbone of America's economy.* These entrepreneurial pioneers, they embody the spirit of possibility -- tireless work ethic; simple hope for something better that lies at the heart of the American ideal. These are the men and women willing to take a chance on their dream. They've got good ideas and then they've got the drive to follow through. They've started mom-and-pop stores and they've got garages they open up and they start tinkering and *suddenly that leads to some of America's biggest, most successful businesses.* Ordinary Americans with a dream to start their own business, they create most of the jobs that keep our workers employed. In fact, over the past decade and a half, *America's small businesses have created 65 percent of all new jobs in this country.*[2] (Emphasis supplied)

[1] Network 1 Financial Securities, Inc. is a FINRA member firm that is approved to engage in investment banking and private placement of securities, in addition to other securities business.

[2] Remarks by the President on the Economy, The White House, Office of the Press Secretary (May 13, 2011). http://www.whitehouse.gov/the-press-office/remarks-president-economy (last visited on March 10, 2011).

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The practical problem for the small business owner – the entrepreneur whose company is not yet a public company -- is finding investors who can and will fund his business so that he can grow his business ultimately so that he can become the next Google or Microsoft.

In an article for Corporate Cashflow Magazine, Gary D. Zeune and Timothy R. Baer explained the nature of the small business man's funding problem and the practical solution to this problem:

> Although most business owners dream of taking their company public someday, many have had to wait years for a traditional public offering. . . .For them, a *private placement of equity or debt has been a quicker, less expensive way to raise a limited amount of capital from a limited number of investors*. A private placement has been appropriate when a company still lacks the financial strength or reputation to appeal to a broad base of investors and cannot afford the expense of a public offering.[3] (Emphasis supplied)

Private placements are considerably less expensive and less time consuming than other sources of funding (these "other sources" will be taken up in the paragraphs that follows). Moreover, private placements may be the only source of capital available to risky ventures or start-up firms because commercial bankers are often slow to lend to small businesses and start-up firms. Andrew J. Sherman echoes this point in his book, The Complete Guide to Running and Growing Your Business:

> With loan criteria for commercial bankers and investment criteria for venture capitalists both tightening, the private placement offering remains *one of the most viable alternatives* for capital formation available to companies.[4] (Emphasis supplied)

Aside from providing money to the small business owner, private placements offer invaluable intangibles: Private Placements enable the small business owner to hand-pick investors with compatible goals and interests. Since the investors in private placements are themselves generally sophisticated business people, private placements enable small business owners to structure more complex and confidential transactions. And, when the investors in private placements are themselves entrepreneurs, they may be able to offer valuable assistance to the company's management without necessarily sitting on the company's board of directors.[5]

These and other rules of thumb are borne out by the United States Government Accounting Office.

Typically, business growth involves seven stages, having capital needs relevant to that stage, each stage having different sources of financing. According to the United States Government Accounting Office, the stages of business growth and corresponding sources of financing looks something like this:[6]

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[3] Quoted in E-Notes: Encyclopedia of Small Business | Private Placement of Securities (March 10, 2011). http://www.enotes.com/small-business-encyclopedia/private-placement-securities/print (last visited on March 10, 2011).

[4] Id.

[5] Id.

[6] Small Business: Efforts to Facilitate Equity Capital Formation, Report to the Chairman, Committee on Small Business, U.S. Senate, United States General Accounting Office (September 2000), at p. 9. http://www.gao.gov/archive/2000/gg00190.pdf (last visited on March 10, 2010).

Stage of Development	Capital Needed	Financing Sources
Seed Stage: Capital needed to prove a concept or develop a product.	Up to $250,000.00	• Entrepreneur's assets • Family • Friends
Start-Up Stage: Financing for product development and initial marketing	$250,000 to $5 million	• Business "Angels" • Early-stage venture capital • Small Business Investment Company • Foundation grants • Government Funds • ***Private Placements***
First Stage: Investment to initiate commercial manufacturing, shipping, or service	$1 million to $5 million	• Business "Angels" • Small Business Investment Company • Venture Capital Funds • Research and development partnerships • Leasing companies • Strategic partnerships • ***Private Placements***
Second Stage: Investment for initial expansion or production.	Up to $10 million	• Venture Capital Funds • Corporate Venture Funds • Venture Leasing Companies • Strategic Partnerships
Third Stage: Investment for plant expansion, marketing, product improvement, or working capital.	Up to $10 million	• Venture Capital Funds • Leverage Buyout Funds
Bridge Stage: Financing to sustain major growth in a company expecting to go public in 6-12 months.	Up to $20 million	• ***Private Placements*** • Venture Capital Funds
Exit / Liquidity Stage via IPO, merger, or acquisition.	$30 million or greater	• Public markets • Private markets

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As this Matrix clearly evidences, Broker/Dealers that are authorized to act as Placement Agents play a critical role in *providing sources of funding* during the **Start-Up Stage**, the **First Stage**, and at the **Bridge Stage** in the development of small businesses.

But before we analyze the role that Placement Agents play in capital formation, it is worthwhile examining the "**cost**" paid by the small business owner when he goes the route of "Business Angels", "Capital Venture Funding", or "Small Business Investment Companies", as these are the more typical alternatives to funding via private placement of securities offered through broker/dealers.

- **Business Angels**: While "Business angels" may be one funding option for the small business owner, this "option" more often than not is more "academic" than practical: Typically, in exchange for his investment, the "Business Angel" seeks to (a) take an active role in advising or even managing the firm, or (b) at a minimum, serve on the board of directors as a passive investor, but in any event (c) take 10 percent or more of a firm's ownership; and (d) generally seeks the ability to liquidate the investment in about 5 to 10 years through a merger, acquisition, or IPO.[7] Thus "Business angel" financing is not desirable for the small business owner seeking to maintain control over the day-to-day operation of the business he started, as well as seeking to keep his company private or at least taking his firm public on *his* time-table and *not the investor's*. Accordingly, private placement financing is the more desirable option for this small business owner.

- **Venture Capital Funding**: Similarly, "Venture Capital Funding" can prove equally less than desirable for many, if not most small business owners. Typically, the venture capitalist seeks to provide incremental financing to small businesses *on the basis of the business' achievement of specific financial and nonfinancial milestones*. The small business owner who started his own company may not want to voluntarily take on these constraints. Even if the small business owner might be willing to agree to this concession, the typical small business owner will find other concessions equally, if not more, burdensome, such as the venture capitalists desire to (a) take 20 to 40 percent ownership of a firm, depending on the amount of capital provided and their valuation of the firm; (b) have the right to liquidate the investment in about 3 to 5 years through a merger, sale, or IPO; and (c) have the right to advise and manage the firm by taking seats on the firm's Board of Directors.[8] Once again, private placement financing is or may be the more desirable option for this small business owner.

- **Small Business Investment Companies**: Small Business Investment Companies[9] could prove an option for the small business owner, so long as certain SBIC prohibitions do not apply to him or his business. Specifically, SBICs may not invest (a) in "other SBICs", in finance and investment companies; (b) in finance-type leasing companies; (c) in unimproved real estate, in companies with less that 51% of their assets or employees in the United States; (d) in companies that will use the proceeds to acquire farm land; (e) in companies whose primary business activity is deemed contrary to the public interest; or (f) in passive or casual businesses (those not engaged in a

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[7] Small Business: Efforts to Facilitate Equity Capital Formation, *supra* at 10.

[8] Small Business: Efforts to Facilitate Equity Capital Formation, *supra* at 10-11.

[9] Small Business Investment Companies or SBICs are privately owned and managed investment funds, licensed and regulated by SBA, that use their own capital plus funds borrowed with an SBA guarantee to make equity and debt investments in qualifying small businesses. The U.S. Small Business Administration does not invest directly into small business through the SBIC Program.

regular and continuous business operations). Thus, for example, a practicing physician who wants to start up new company separate from his medical practice in order to develop a medical treatment, such as a therapeutic ointment, might not qualify for an SBIC loan. Similarly, a start-up company seeking to offer certain foods or specially prepared foods (e.g., kosher or halal) unique to and currently unavailable to certain ethnic groups, would not likely be a candidate for small business investment company financing unless it is already a "going concern".[10] Once more, private placement financing is or may be the more desirable option for this type of small business owner.

In short, private placement of securities is the *funding source of choice* for small business owners and start-up companies:

- Seeking an infusion of capital in an amount ranging from $1 million to $5 million,
- Without committing himself to having investors insisting that they be involved in the day to day affairs of the firm, or
- Without insisting that they sit on the board of directors as "passive investors to protect their investment", or
- Without demanding that the company attain prescribed benchmarks or that the company be taken public within a prescribed timeline that may prove to be an unreasonable business plan or not in the interest of existing stockholders.

In addition to these very important factors, the critical advantage offered by private placement is ***timing and speed to distribution of financing.***

2. Private Placement Rule 5122 Must Support the *Practical* Purpose of Enabling Placement Agents to be *Effective* in Bringing Sources of Funding to Small Business.

Timing is, perhaps, the *single most important advantage* that private placements bring to the table when funding the small business owner's financial need.

Recalling the insights of Messrs. Zeune and Baer, "private placement of equity or debt has been a *quicker*, less expensive way to raise a limited amount of capital from a limited number of investors."[11] (Emphasis supplied).

Prior to or at the time when they are provided to an investor, offering documents (i.e., term sheets, private placement memoranda, etc.) must be filed by FINRA member firms via email with FINRA Corporate Financing Department.

This requirement is, *in form*, the same requirement that exists in both existing and proposed Rule 5122.

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[10] SBIC Program: Seeking SBIC Financing for your Small Business, http://www.sba.gov/content/sbic-program (last visited on March 10, 2011).

[11] Quoted in E-Notes: Encyclopedia of Small Business | Private Placement of Securities (March 10, 2011). http://www.enotes.com/small-business-encyclopedia/private-placement-securities/print (last visited on March 10, 2011)

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However, when combined with the proposed change to Rule 5122 relating to *disclosures about compensation and use of proceeds*, the Rule 5122 filing requirements *now substantively and adversely* affect the *timing advantage and speed to distribution* traditionally offered by private placements. This subtle but significant change in Rule 5122 prompted the law firm of ***Wilkie Farr & Gallagher LLP*** to offer this caution to broker/dealers:

> [A] broker-dealer may want to *wait for confirmation* that the FINRA staff has no comments before the broker-dealer begins to sell the issuer's interests. Otherwise, *the broker-dealer runs the risk of receiving objections to the disclosure from FINRA staff well after an offering closes, when, as a practical matter, changes to the disclosure can no longer be made*.[12] (Emphasis supplied)

There is another dynamic operating here. Existing Rule 5122 applies solely to private placements of securities *issued* by FINRA member broker/dealers and certain affiliated entities. But, proposed Rule 5122 will make "any participation" subject to regulatory *liability*. According to the law firm of ***Pryor Cashman LP***:

> Under FINRA Rule 5110(a)(5) [the Rule that defines "participation"], participation in an offering includes "preparation of the offering or other documents, participation in the distribution of the offering on an underwritten, non-underwritten, or any other basis, furnishing of customer and/or broker lists for solicitation, or participation in any advisory or consulting capacity to the issuer related to the offering." Thus, any member firm that provides consulting services or other support for an offering, even if not acting as a placement agent, would have (or at least share) responsibility for seeing that the requirements of Rule 5122 are met.[13]

This change from "private offerings by FINRA firms of securities issued by affiliates" to "any participation" gives rise to an additional factor that substantively and adversely affects the traditional timing advantage and speed to distribution offered by private placements. ***Pryor Cashman LP*** speaking through the author, Stephen M. Goodman, Esq., elaborates:

> ... [A] member who *participates in an offering by an unaffiliated issuer* clearly could *risk* a FINRA *enforcement action* for breach of the Rule (which the issuer would not) if the issuer's broker compensation and use of proceeds disclosures were found to be less than complete. (Emphasis supplied)

This enforcement risk and liability can be mitigated only by taking on a separate due diligence *over and above* the private placement due diligence imposed by Regulatory Notice 10-22 (relating to Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings). Again, Mr. Goodman explains:

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[12] Rita M. Molesworth, Esq., Martin R. Miller, Esq., and Marc J. Lederer, Esq., FINRA Proposes to Further Regulate Certain Private Placements Sold by Broker-Dealers, The Law Firm of Wilkie Farr & Gallagher, LLP (New York, Washington, Paris, London, Milan, Rome, Frankfurt, Brussells) (January 27, 2011) at p. 2 (last visited on March 10, 2010).
http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C3661%5CFINRA-Proposes-To-Further-Regulate.pdf.

[13] Stephen M. Goodman, Esq., FINRA Seeks to Monitor Broker Compensation in Non-Member Private Offerings Through Pre-Filing Requirement, Pryor & Cashman, LLP (February 2011) (last visited on March 10, 2011).
http://www.martindale.com/members/Article_Atachment.aspx?od=415643&id=1244496&filename=asr-1244442.FINRA.pdf

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This risk is magnified if more than one member has "participated" in the placement. For example, the issuer may have engaged one member as a consultant, received an introduction to an investor from another and use yet a third as the placement agent. Potentially, each of these members could be held responsible if the issuer's offering document fails to disclose the role which each of them played and how much each of them has been compensated.[footnote omitted] *As a result, the amended Rule may compel a participating member to conduct due diligence to verify whether other members are involved.*(Emphasis supplied)

Thus, broadening Rule 5122 to involve "any participation" of a private placement offering will necessarily impose additional due diligence, having the practical effect of substantively and adversely *slowing down* the traditional *timing advantage and speed to distribution* offered by private placements. This point is well expressed in the aforementioned article offered by ***Wilkie Farr & Gallagher LLP***:

> Because Rule 5122 would be applicable to any offering in which a FINRA member participates, not just those issued by a FINRA member or certain affiliates, many more offerings would be subject to the disclosure, filing and use of proceeds requirements of the rule. FINRA members would need to determine *before* participating in any private placement offering whether one of the exemptions is available and, if none is, file the offering document with FINRA's Corporate Financing Department and comply with the other requirements of Rule 5122. Additionally, FINRA members may *require additional undertakings from private placement issuers to comply with Rule 5122. For example, a FINRA member that is not affiliated with the issuer would not otherwise be in a position to know or control whether the use of proceeds by an issuer in an offering it is marketing is consistent with the disclosure in the offering document and in compliance with the rule.*[14] (Emphasis supplied)

In short, FINRA member firms will, arguably, be *reluctant to commence promotion of a private placement offering until the unknown* (namely, whether FINRA will raise questions regarding the accuracy and completeness of disclosures relating to member compensation and the use of proceeds) *is first resolved by FINRA*.

Still, there is yet one more obstacle: According to Regulatory Notice 09-27 (relating to SEC Approves New FINRA Rule 5122 Relating to Private Placements of Securities Issued by a Member Firm or a Control Entity), while FINRA staff issues "no objection" letters in public offerings, FINRA staff does not do this in private offerings.[15] This can only serve to further chip away at the traditional *timing advantage and speed to distribution* offered by private placements.

Although amended Rule 5122 allows an underwriter to proceed with an offering so long as the offering documents are timely filed with FINRA Corporate Financing and while FINRA staff reviews these documents, it is our concern that this procedure would *in practice* prevent members from distributing any offering documents, not knowing whether FINRA staff believes that these offering documents are

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[14] Rita M. Molesworth, Esq., Martin R. Miller, Esq., and Marc J. Lederer, Esq., FINRA Proposes to Further Regulate Certain Private Placements Sold by Broker-Dealers, *supra*.

[15] "Notably, the filing requirement [of Rule 5122(b)(2) differs from that in Rule 5110 (Corporate Financing Rule) in that FINRA staff will not review the [private placement] offering and issue a "no-objections" letter before a member may commence the [private placement] offering." FINRA, Regulatory Notice 09-27, at p. 4.
http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118735.pdf (last visited on March 10, 2011).

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adequate for investor protection. *The delay that can only be inevitable from a broker/dealer's hesitation to commence promotion will damage the private placement process and the speed in which capital raises occur.* In support of this critical point, it bears mentioning this significant difference between initial public offerings (IPOs) and private placements: While new public issues are normally distributed to non-accredited investors, private placements are distributed to institutional investors, accredited investors, and limited sophisticated investors who otherwise qualify to participate. One of the key attributes of private placements is that they be accomplished more quickly for the companies requiring capital sooner rather than later. In short, *speed to distribution* that companies, especially the small business owner and start-up companies, need in order to react to changing markets is the single most important factor will be adversely affected by proposed Rule 5122.

3. Revised Rule 5122 Cannot be a "One Size Fits All" that Fails to Understand the Compensation Element that Incentivizes Placement Agent to Find Investors for Small Business Owners and Small Public Companies by means of Private Placements.

We have attempted to demonstrate in Section 1 of this Comment Letter that the small business owner and start-up company is simultaneously "*the backbone of America's economy*" (to quote President Obama) and is a market that is best served by private placements.

But, while the number FINRA member firms offering investment banking, fewer still are those that service the small-cap private placement market -- "*the backbone of America's economy*". This point is underscored in A Primer on How to Offer and Sell Securities, by Joseph P. Hildebrandt, Esq., of the law firm of ***Foley & Lardner***. Mr. Hildebrandt writes:

> Certain observations should be made before proceeding farther:
>
> Generally, investment bankers *will not take on an underwriting* (best efforts or firm commitment) *if the amount involved is less than $5 million*; the larger investment houses will rarely go below $15-$20 million.
>
> It is *rare* for an investment banker *to finance a start-up*. "Trophy" management and a great mouse trap are required for them even to consider it.
>
> Any *stock priced below $5 per share is anathema* to investment houses as such stock is "penny stock" as interpreted by the regulators and thus subject to certain burdensome rules relating to disclosure and suitability.
>
> A Regulation A offering will not usually satisfy an investment banker as audited financials are not required by federal rules and, also, the *bankers will want the company to be a "Reporting Company,"* which is not the result of a Reg A Offering. (Emphasis supplied)[16]

Mr. Hildebrandt cautions the start-up, small business owner that he will be fortunate, indeed, if he can find an investment banker willing to place his securities privately to investors unless his financial need for funding is in excess of $5 million; even then, the small business owner must understand that most

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[16] A Primer on How to Offer and Sell Securities, Joseph P. Hildebrandt, Esq., *Foley & Lardner* (2002). http://www.foley.com/files/tbl_s31Publications/FileUpload137/589/primer_offersec.pdf (last visited on March 10, 2011).

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investment bankers will not even look at the small business owner's company unless the company is already a reporting company having price per share of $5 or more.

This reality is bad news for most start-up and small business owners.

The good news is that the American economy is fortunate that there still exist a few FINRA member broker/dealers approved to engage in investment banking whose business model includes servicing these small business owners and small-cap companies that are public or non public companies, whose equity stock is essentially par value and who have need to raise capital in amounts less than $5 million.

The bad news is that, unless proposed Rule 5122 is adjusted to take into consideration the compensation that is typical for the traditional private placement of securities or PIPE offerings, the vast number of small business owners will be unable to find investors who will provide desperately needed capital to grow these small-cap businesses.

Finding investors is the essential service that Broker/Dealer Placement Agents provide to the small business owner and small-cap companies.

It is in the very nature of things that the small private or small public companies are cash poor. Its owner would not be willing to exchange equity in his company for investor capital infusion but for the fact that the small business owner is typically stripped down to essential cash needed for day-to-day operations. It is very rare that the small business owner can pay substantial amounts of cash as compensation to the placement agent in exchange for finding investors.

It is for this reason that, in the typical placement agent agreement with the broker/dealer, some of compensation paid to the broker/dealer will be in the company's stock[17] or warrants..

Because the stock paid to the placement agent has a limited market value, the "real" compensation paid to the broker/dealer placement agent are the "commissions" deducted from the gross dollars paid by the accredited investor in exchange for his or her equity-ownership investment in the company. Part of these commissions is retained by the broker/dealer, with the balance paid to registered representatives. In smaller placements this leaves very little to be used for the due diligence and administrative functions. In effect it's the stock or warrants portion of the compensation that rewards the placement agent for the effort and risk incurred in the transaction. Without the compensation of stock and warrants there will be much fewer broker/dealers willing to participate in the smaller private placement offerings.

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[17] It is the custom and usage of the industry that the price of the stock is negotiated between the company-issuer and the private placement agent. This negotiated price in reflected in the term sheet and in the private placement memorandum, if there is one. However, saying that the stock is priced at "x" does not necessarily mean that the stock has an objective current market *value* at this price. Indeed, in as much as the stock received by the placement agent is generally "restricted stock" that cannot be traded for at least six (6) months, this stock is essentially without market value at the point of sale. Moreover, until the company becomes listed on a national exchange, or on NASDAQ, OTC Bulletin Board, or the Pink Sheets, the stock's value continues to remain "without current market value" because it cannot, as yet, be publicly traded. One is inclined to use the word *essentially* "without current market value" because the holder of such stock could, theoretically, sell such stock in a so-called "Section 4 and ½" private transaction, assuming a purchaser can be found. These possibilities notwithstanding (and they are essentially theoretical possibilities because of regulatory gray areas surrounding "Section 4 and ½" private transactions), until the company "goes public" or until a "ready and willing" private purchaser for this stock can be found, the stock paid to the placement agent as compensation for offering a company/issuer's securities in a private placement offering is *essentially* "without current market value".

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While the amount of compensation paid to the broker/dealer placement agent may, *in isolation*, appear substantial in the eyes of the customer and indeed a regulator, such compensation needs to be appreciated in the broader picture.

The time and effort in researching the companies and finding the proper accredited investors is much greater than the effort in marketing most financial instruments. Making sure that the broker/ dealer has done the proper due diligence on the company and the proper suitability investigation on the investors is an expensive and time consuming function. The time, effort, and expense does not differ due to the size of the offering. Therefore, the only way to properly reward the placement agent in the smaller placements is with a substantial equity kicker.

It should also be noted that Rule 5122 limited the compensation between parties that were affiliated or associated. The expansion of the rule to non related entities interferes with the free market system of negotiations between parties. Currently companies are free to seek an agreement with a number of placement agents and negotiate the compensation terms. By amending the rule to unrelated parties you are interfering with the free market system and it will have a negative effect on the capital formation process in the market and companies ability to raise capital. Currently companies can search for the best deal they can obtain. Once maximum compensation amounts are established by regulatory bodies an industry tends to seek that level.

At the moment, it is unclear whether FINRA intends to combine this "equity kicker" with commission dollars when calculating the 15% percentage of offering proceeds that may be used for offering costs and compensation.[18] To further compound this ambiguity, Rule 5122 proposes to "replace the phrase 'any other cash or non-cash sales incentives' with the phrase 'any other compensation to participating broker-dealers or associated persons.' "[19] This change offers no clarification whether "equity kickers" in a traditional private placement offering will or will not be included when calculating the 15% percentage of offering proceeds that may be used for offering costs and compensation.[20]

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[18] FINRA Regulatory Notice 11-04, at p. 4.
http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122787.pdf (last visited on March 10, 2011). In smaller private placements this compensation adjustment usually took the place of an increase in non-cash items such as common stock or warrants. By including these items in the 15% compensation allowed it will severely affect the ability of smaller companies or companies requiring a smaller capital infusion to achieve their goals. As an example a company looking to raise $1 million in a private placement would be allowed to compensate their agent for $150,000. After legal, due diligence, selling expenses and administrative charges in most cases this would not be a profitable transaction for the pay placement agent. However, many placement agents were incentivized to do these transactions based on the prospects of the underlying company and the ability to obtain an equity position in this client.

[19] FINRA Regulatory Notice 11-04, at p. 5.

[20] "Equity Kickers" paid to Placement Agent in a PIPE (i.e., private investment in a public entity) do not result in "*sine*-CMV" (i.e., "without current market value") stock. This is because PIPE's stock is stock of an already publicly trading company. Thus, while stock paid to Placement Agents in a traditional private placement is stock "without current market value", stock paid to Placement Agents in a PIPE does have a current market value since the stock is trading on the market. To the extent that the Placement Agent receives "restricted stock", arguably the Placement Agent does not have stock that has *current* market value since the Placement Agent must wait at least six (6) months before the Placement Agent can deliver this stock to a clearing firm for trading. Arguably, then, the Placement Agent's stock has *future* market value determinable at a fixed date in the future; of course, the price at this determinable set date in the future could be lower than the price of the stock on the date that the Placement Agent received it. In either event, these factors point to an important theme in Section 3 of this Comment Letter, which is that **Rule 5122 cannot be a "One Size Fits All" rule**. Rulemaking must take into consideration that compensation paid in stock to Placement Agents in a traditional private placement is "sine CMV" stock, whereas stock paid to Placement Agents in PIPE is stock that technically has *current* market value at the time of receipt or, more plausibly, has an *ascertainable future* market value determinable on a fixed future date. The currently disputed question in Rule 5122 -- whether or not stock paid as compensation in a private placement transaction should be **included or not included in the 15% compensation limits** of Rule

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These proposed changes produce an ambiguous situation that will make the sale of other securities products more attractive (after weighing the compliance, regulatory, and customer liability risks of private offerings in comparison to other securities product offerings) and have the potential for driving broker/dealer and their registered representatives away from the private placement of securities practice in the small-cap financing market. Include "equity kickers" with commission dollars when calculating the 15% percentage of offering proceeds that may be used for offering costs and compensation will remove the vital incentive that keeps broker/dealers in the niche small-cap private placement market.

It is important to recognize that "acquisitive spirit" is the *passion* that drives investor and broker alike to participate in the securities market place.

It is in the nature of things that investors want to "buy low, sell high", just as it is in the nature of things that brokers are in the securities market to service, and be compensated for servicing, this "acquisitive spirit" of the investor. It is in the nature of things that this "acquisitive spirit" is what drives the conduct of both parties.

Rule making should be cognizant of this *shared passion,* and should focus on controlling the effects, not removing the cause, of "mischief" created by this passion. Attempts at removing this "acquisitive spirit" in the broker/dealer and its registered representatives, even if guided by well-meaning mission of "investor protection", will only serve to throw out the baby with the bathwater, or in the words of James Madison, gives rise to a remedy that is worse than the disease, that is, destroying the passion (i.e., the "acquisitive spirit") that which is essential to the existence of our securities market, facilitation of capital formation at home, stopping the exodus of capital overseas,[21] and ultimately rebuilding our national economy.[22]

5122 -- **needs to be analyzed differently depending on whether the transaction is a traditional private placement or whether the transaction is a PIPE.**

[21] *See* Footnote 3 in NASD Amicus Curia Motion and Brief in the case of Credit Suisse Securities (USA) LLC, et al. v. Glen Billing, et al, wherein legal counsel for NASD states: "Although it is a complex question, driven by many variables, the Nation's IPO markets face vigorous competition from foreign markets. *See, e.g., Battle of the Bourses—Financial Exchanges*, Economist, May 27, 2006, at 65 ("In 2000 nine out of every ten dollars in the world's initial public offerings were raised in America. [In 2005] nine out of every ten dollars were raised outside America . . . ."). While the Credit Suisse case centers on alleged manipulation in the Initial Public Offering markets by broker/dealers, Footnote 3 has relevance for assessing concern over "overseas exodus" trends in connection with the broader capital formation market, which of course includes private placements.

[22] James Madison and Alexander Hamilton taught valuable lessons that have relevance for discussion about governance, rules, and rule changes that affect the securities market place.

In Federalist Essay #10, Madison teaches: If you are going to have limited government, a premium must necessarily be placed on individual liberty, recognizing that with the blessings of liberty inevitably come many "mischiefs". To cure "mischief", governing bodies have a choice: They can either *remove the cause* of these "mischief" or they can make a good faith effort to *control their deleterious effects*. Madison cautions against resorting to the first solution because this remedy is worse than the disease.

In his various economic reports on manufactures, banking, and the public credit, Hamilton teaches: "To cherish and stimulate the activity of the human mind, by multiplying the objects of enterprise, is not among the least considerable of the expedients, by which the wealth of a nation may be promoted." Report on Manufactures (December 1791). President Obama recently stated that "Hamilton had a strong belief in the power of the market, but he balanced that belief with a conviction that human enterprise, and I quote, "may be beneficially *stimulated* by prudent *aids and encouragements* on the part of the government." (President Obama, 29 March 2008). Thus, if you are going to have limited government that is dedicated to economic freedom for the common good and common prosperity, you must give freedom to the passion (e.g., the spirit of acquisitiveness) that drives the individual citizen in market place.

4. **The Federal securities laws require regulator to strike a balance between investor protection and the corresponding obligation to facilitate capital formation when crafting rules.**

We believe that FINRA Rules in general and the amendments to FINRA Rule 5122 specifically must strike a balance between investor protection and the conflicting obligation to facility capital formation.

We are aware that, in recent a FINRA response to address industry comments in connection with File No.SR-FINRA-2009-077, FINRA, speaking through its Capital Markets Policy Department, stated, "As an initial matter, we note that SRO rule filings do not require a finding that the proposed rule promotes efficiency, competition and capital formation."[23]

It may be that FINRA has recently changed its mission, but at least as far back as 1998, FINRA (then NASD) officially declared that facilitating capital formation is part of its mission.
It its own words, FINRA (formerly, NASD) has stated:

> The National Association of Securities Dealers, Inc. (NASD®) was organized under the 1938 Maloney Act amendments to the Securities Exchange Act of 1934 to address the U.S. securities industry's need for self-regulation.
>
> The Maloney Act authorized the U.S. Securities and Exchange Commission (SEC) to register voluntary national associations of broker/dealers for the purpose of regulating them- selves under SEC oversight. Every U.S. securities firm transacting business with the public is currently required by law to be an NASD member.
>
> NASD's founding mandate was to standardize the securities industry's principles and practices, to promote high standards of commercial honor, to advance just and equitable principles of trade for investor protection, to adopt and enforce fair practice, and to foster member observance of federal and state securities laws.
>
> The NASD, taking direction from the SEC in 1963, *adopted as another tenet of its self-regulatory mandate, the promotion of capital formation* by developing, operating, and regulating fair and efficient securities markets.[24] (Emphasis supplied).

This Country was built on the "acquisitive spirit" and protecting this spirit (i.e., controlling the harmful effects rather than removing the cause of "mischief" attending to this spirit) is the business of governing bodies in the securities market place. Every rule, and change to a rule, implicates governance.

In the wake of recent scandals such as the Madoff scandal, it may, on the surface, seem reasonable for rulemaking to take a more aggressive approach. However, the superior view is that governance should remain steady whether the times are principled or scandalous.

Governance aims simultaneously at two principles: Justice, but also Practicality. Justice is represented, symbolically, by scales balancing conflicting interests. Here, "investor protection" must be balanced with "capital formation", requiring a *practical* exercise of judgment that takes into consideration the *realities of business*.

[23] FINRA Letter to the U.S. Securities & Exchange Commission (March 10, 2010) (last visited on March 10, 2011) http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p121142.pdf

[24] NASD Annual Report (1998) (last visited March 10, 2011).
http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p009760.pdf

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In 1998, NASD (now FINRA) officially states its mission as follows:

> **MISSION** To *facilitate capital formation* by creating the markets of choice – operated and regulated to achieve the most liquid, cost-efficient, technologically-advanced, and fair securities markets in the world – for the benefit and protection of investors.[25] (Emphasis supplied)

More recently, FINRA has represented to the United States Supreme Court that facilitating capital formation is part and parcel of its mission.

In its Motion For Leave to File Amicus Curiae Brief and Brief of the National Association of Securities Dealers, Inc., as Amicus Curia Supporting Petitioners submitted to the Supreme Court on January 22, 2007, in the case of Credit Suisse Securities (USA) LLC, et al. v. Glen Billing, et al, Dkt. 05-1157, NASD represented, throughout, that facilitation of capital formation is one of its objectives.[26]

In the Argument Section, Subsection A of Section 1, the caption reads: "The NASD Regulates The Broker-Dealer Industry In Order to Promote Competition As Well AS Market Suitability *and Capital Formation*."[27] (Emphasis supplied)

At page 10 of the Amicus Curiae Motion, Counsel on behalf of NASD writes: "The legislative history reflects the fact that competition is not the only consideration relevant to the SEC's and NASD's regulatory policies. Other objectives of the securities laws include the promotion of capital formation and a stable securities market. See 15 U.S.C. § 80a-2(c)."[28]

Earlier, in the Summary of Argument, Counsel for NASD writes:

> Congress intended for the regulation of the securities market to rest with an expert agency, *the SEC, and with the expert SROs, including the NASD,* that operate under the SEC's close regulatory oversight. Pursuant to this regulatory authority, the SEC and SROs *have established a carefully reticulated securities regulatory regime that* – unlike the antitrust laws – *promotes both competition and other, perhaps conflicting interest, including market stability and capital formation.* 15 U.S.C. §77b(b) . . . *Moreover, to safeguard the capital formation process, the SEC and NASD modify their rules when needed to respond to rapidly changing market conditions.*[29] (Emphasis supplied)

[25] NASD Annual Report (1999), at p. 28 (last visited on March 10, 2011).
http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p009759.pdf

[26] NASD Amicus Curia Motion and Brief, http://apps.americanbar.org/antitrust/at-committees/at-exemc/pdf/main-exemptions/implied-immunity/Amicus-Brief-of-NASD.pdf (last visited on March 8, 2011). The disputed question in this case was whether a cause of action is available under the federal antitrust laws to challenge alleged collusive conduct and market manipulation in initial public offerings by underwriters and institutional investors. Although this disputed question is not essential to the argument of the instant Comment Letter to Proposed Rule 5122, the policy statements recited in this Amicus Curia Motion and Brief made by legal counsel on behalf of the National Association of Securities Dealers, Inc. ("NASD") substantiate the argument that "facilitation of capital formation" is, indeed, one of the missions of NASD, now FINRA.

[27] NASD Amicus Curia Motion, *supra* at p. 10.

[28] NASD Amicus Curia Motion, *supra* at p. 10.

[29] NASD Amicus Curia Motion, *supra* at p.8.

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This truth of this statement is supported outside this Brief.

Whenever NASD/FINRA filed/files a proposed rule change with the U.S. Securities and Exchange Commission ("SEC"), the SEC reviews and then either approves or rejects a rule change based on the following assessment:

> "In reviewing the proposed rule change, the commission considered its potential impact on efficiency, competition, *and capital formation.* 15 U.S.C. 78c(f)". (Emphasis supplied)

Or

> "In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, *and capital formation.* 15 U.S.C. 78c(f)." (Emphasis supplied)[30]

In any event, the Conclusion to the Motion for Amicus Curiae states:

> *Capital formation through a robust, stable, and efficient securities market is essential to this Nation's economy. Congress has fostered a tremendously successful securities system by establishing a comprehensive regulatory framework that, under the expert guidance of the SEC and SROs [including the NASD], has promoted capital formation, protected investors, and prevented fraudulent conduct by market participants.*[31] (Emphasis supplied)

5. Conclusion.

It is hoped that FINRA will take these comments in the spirit of respect and constructive criticism with which they are offered.

It is hoped that FINRA will modify both the existing and proposed Rule 5122 in a manner that takes into consideration:

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[30] This phraseology come from the SEC's stated mission, which is: "The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." *See* The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited on March 8, 2011). The statutory authority for this official mission statement is Section 2(b) of the Securities Act (relating to Consideration of Promotion of Efficiency, Competition, and Capital Formation), which reads as follows:

> "Whenever pursuant to this title the Commission is engaged in rulemaking 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."

See Securities Act §2(b) amended by the National Securities Market Improvement Act of 1996 ("NSMIA"), 106(a), 110 Stat. 3416, 3424) (codified at 15 U.S.C. Pub.L. No. 104-290, Section 3 of the Exchange Act and section 2 of the Investment 77b(b)). § 3(f) (as See Exchange Act § Company Act of 1940 contain similar provisions. 106(b), 110 Stat. at 3424-3425) (codified at 15 U.S.C. amended by NSMIA § 2, 54 Stat. 78c(f)); Investment Company Act of 1940, Pub.L. No. 76-768, § § 106(c), 110 Stat. at 3425) (codified at 15 789, 790 (as amended by NSMIA § 80a-2(c)).

[31] NASD Amicus Curia Motion, *supra* at p. 25.

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a. The small business owner, start-up, and small-cap companies that Private Placements were designed to service.

b. The importance of *speed to distribution* that companies, especially the small business owner and start-up companies, need in order to react to changing markets.

c. The importance of *timing advantage* that private placements offer to the small business owner, start-up and small-cap companies.

d. The importance of *finding investors is the essential service* that Broker/Dealer Placement Agents provide to the small business owner and small-cap companies.

e. The importance of "equity kickers" at the point of sale: The hope being that "equity kickers" will be recognized as a vital incentive that keeps broker/dealers in the niche small-cap private placement market; the hope being that "equity kickers" will not be included with commission dollars when calculating the 15% percentage of offering proceeds that may be used for offering costs and compensation.[32]

f. The importance of the "acquisitive spirit" in capital formation and keeping capital home, which is essential to the existence of our securities market, capital formation, and ultimately our national economy.

g. The importance of striking a balance between investor protection and the conflicting obligation to facilitate capital formation so that (i) accredited investors,[33] (ii) the company issuer, (iii) the placement agent, and (iv) the national economy will benefit from the proposed revision of Rule 5122.

h. The desperate need for U.S. markets to continue to be ***the*** place where small companies with new technologies and sciences can go to obtain the crucial capital to realize the American dream.

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[32] The concern that needs to be considered is "what value?" is placed on any equity or warrants positions retained by the Placement Agent.

The formula used in the *public* offering corporate finance situation *does not apply* when one is considering private placement transactions. Most equity earned would be of a restricted kind, much the same as the attributes of the investment itself. Therefore the intrinsic value of this equity is significantly diminished by its very nature. The Placement Agents is in effect in the same position as the investors with regard to these securities. Therefore, a new formula must be arrived at in order to place a proper value on this compensation *if* they must be considered in the 15% compensation pool.

We respectfully suggest that, in all private placements under $10 million, the 85% offering costs and compensation rule should be applied to the *cash portion of the investment, only.* Any equity or warrant position earned by the Placement Agent should be removed from consideration under this new rule because this pivotal fact: When the Placement Agent and the Issuer are unrelated, there is no ownership or control relationship between the parties. In the case of *unrelated* parties, compensation is a bona fide *negotiated* compensation. And while the "investor protection" duty may still require disclosure, the amount of compensation should be left to the free market in order to better serve the company's capital requirements and better serve the capital formation mission of the regulators.

[33] Finally, it is essential that we all remember who the investor is in the context of "investor protection". In a private placement, the investor is not a "mom & pop" retail investor; the investor is either an "institutional" investor [e.g., FINRA Rule 3110 (b)(4)(A)] or an "accredited" individual investor [e.g., Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act] or, if he/she be one of the allowable 35 non-accredited investors, he/she must be a "sophisticated" investor. In short, this type of investor does, by rule, does not require the same level of protection that the retail customer requires.

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Respectfully yours,

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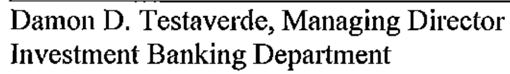

By: ______________________________
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