Rothwell Consulting LLC

E-Mail: suzanne@suzannerothwell.com Telephone: 703-255-6273

June 27, 2017

Submitted via email to: pubcom@finra.org

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
Financial Industry Regulatory Authority, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1506

Re: FINRA Regulatory Notice 17-15
Request for Comment on Proposed Amendments
To FINRA Rule 5110 (The Corporate Financing Rule)

Dear Ms. Mitchell:

This letter is submitted in response to the request for comments published by the Financial Industry Regulatory Authority, Inc. ("FINRA") in FINRA Regulatory Notice 17-15 (April 2017) (the "Notice") with respect to proposed amendments to FINRA Rule 5110 (the "Corporate Financing Rule" or "Rule 5110") (the "Rule Proposal").

GENERAL COMMENT

In general, I support the Rule Proposal as it represents a significant clarification and modernization of a complex rule and appropriately narrows certain applications of the rule, thereby facilitating capital formation and decreasing the compliance burden of FINRA members without impacting investor protection. In particular, I support the narrowing of underwriting compensation to those items received by participating FINRA members for "underwriting, allocation, distribution, advisory and other investment banking services in connection with the public offering . . . ." The reorganization of the rule will facilitate the ability of FINRA members and their counsel to comply with the substantive requirements of Rule 5110.

Changes like the extension of the time for initial filing, the reduction of documents and information required to be filed, and the exclusion of the issuer from the definition of "participating member" are positive steps toward reducing some of the unnecessary burdens of compliance with the Corporate Financing Rule. Other proposed amendments would clarify important concepts, such as the proposed definition of "overallotment option" and the addition of supplementary material that provides an expanded list of the items that are included and excluded from underwriting compensation. In a number of cases, the proposed amendments are needed updates or corrections of current requirements, as is the proposal to revise to current Rule 5110(f)(2)(K) such that the prohibition on a FINRA member's participation in an offering if the issuer hires unregistered person to distribute securities will no longer be unnecessarily limited to situations involving a "non-underwritten issue of securities."

Following are my detailed comments on several aspects of the Rule Proposal.[1]

SPECIFIC COMMENTS

Clarify that Underwriting Compensation Will be Limited to Payments Made within the Review Period

The proposed definition of "underwriting compensation" in Section (i)(22) of the Rule Proposal would replace the current requirement that all items of value aquired by a participating FINRA member within the current 180-day review period be included in underwriting compensation by limiting underwriting compensation to "any payment, right, interest, or benefit . . . for underwriting, allocation, distribution, advisory, and other investment banking services in connection with a public offering." Although the Notice indicates that "FINRA would consider payments and benefits received during the applicable review period in evaluating underwriting compensation," the Rule Proposal does not include a provision that makes this clear. The only items of underwriting compensation proposed to limited to those acquired/received during the "review period," as proposed to be defined in Section (i)(20), are the equity and equity-linked securities identified in Supplementary Material .01(a)(7).

Clearly this change is unintended, as the Rule Proposal in its current form would, for the first time, include in underwriting compensation all payments (other than securities) were received for underwriting and other investment banking services in connection with the public offering regardless of when acquired or an agreement was entered into, thereby expanding the scope of Rule 5110 in an unprecedented manner.

This is to recommend that Section (a)(1) of the Rule Proposal, the definition of "underwriting compensation" in Section (i)(22) of the Rule Proposal, and/or the introduction to Supplementary Material .01(a) of the Rule Proposal be revised to clarify that only payments made and securities acquired during the review period will be included in underwriting compensation.[2]

---

[1] This letter solely represents my views and focuses only on certain aspects of the Rule Proposal. I agree with many of the more complete comments submitted by SIFMA in its letter dated June 1, 2017.

[2] *See* current Rule 5110(d)(1).

Reference a Standard for Determining When the Amount of Underwriting Compensation is Unfair and Unreasonable

Proposed Section (a)(1) sets out the general standard that "[n]o member shall participate in a public offering in which the terms and conditions relating thereto, including aggregate amount of underwriting compensation, are unfair and unreasonable pursuant to this Rule . . . ." (emphasis added). However, there is no reference in the text of the Rule Proposal to any standard for determining when the aggregate amount of proposed underwriting compensation is unfair and unreasonable. Such a codified standard appears necessary in order for FINRA staff to have a basis in the rule for its determination that the aggregate amount of underwriting compensation proposed for a public offering is unfair and unreasonable.

This is to recommend that FINRA include a provision that prohibits "participation in a public offering in which the aggregate amount of underwriting compensation exceeds the currently effective FINRA Corporate Financing underwriting compensation guideline."[3] Such a prohibition may be added to Section (f), which lists unreasonable terms and arrangements.

Publish the Rule 5110 Underwriting Compensation Guideline

The FINRA Corporate Financing underwriting compensation guideline (the "Guideline")[4] is a detailed chart of the maximum amount of underwriting compensation that differentiates between the amount of the offering proceeds, the type of securities offered, whether the offering is an initial or a follow-on offering, and whether the offering is underwritten on a "firm commitment" or a "best efforts" basis.[5] FINRA does not publish the Guideline for offerings that are subject to the compensation limitations of the Rule 5110.[6]

Many years ago, the National Association of Securities Dealers, Inc. ("NASD"), the predecessor to FINRA, Board of Governors concluded that it would be potentially harmful for the NASD to publish "approved" levels of underwriting compensation for corporate and other offerings subject to the compensation limitations of the version of Rule 5110 that existed at that time. The position of FINRA has been that the compensation guidelines are not levels which FINRA recommends but represent the maximum permissible levels to which FINRA will not object.[7] The NASD previously published statistics in NASD Notice to Members 92-53 (Oct.

---

[3] *See* FINRA Rule 5110(c)(2)(D).

[4] It is my understanding that the compensation guideline has remained unchanged for several decades and there appears to be no plan to revise it.

[5] These details are currently set forth in FINRA Rule 5110(c)(2)(D).

[6] The only exception is that FINRA Rule 2310, governing offerings of direct participation programs and real estate investment trusts that will not be listed on a national securities exchange, includes the underwriting compensation limitation of 10 percent for any size offering.

[7] The FINRA underwriting compensation guideline chart has been reviewed by Securities and Exchange Commission staff in the context of its review of prior major revisions to the Corporate Financing Rule. *See* NASD Notice to Members 92-28 and attached Securities Exchange Act Release No. 30537 (April 15, 1992); 57 F.R. 77 (April 21, 1992).

1992) regarding the amount of underwriting compensation that was charged by members in the NASD's review of public offerings.

The absence of reliable information for FINRA members and their counsel as to the permissible level of underwriting compensation for offerings of various characteristics too often results in the submission of offerings to FINRA with excessive underwriting compensation, which leads to repetitive submissions by counsel in order to revise the compensation structure to come within an unknown limitation. While it is often thought that there is general knowledge about the Guideline for "firm commitment" underwritten initial public offerings ("IPO" or "IPOs") at the maximum offering proceeds included in the Guideline, my experience is that associated persons of FINRA members and their counsel often mistakenly believe that this amount is 10 percent. There is considerably less knowledge about the Guideline for follow-on and "best-efforts" underwritten offerings.

Given FINRA's current review of the Corporate Financing Rule, this is to request that FINRA reconsider its policy to maintain the confidentiality of the Guideline. The publication of the Guideline will assist issuers, underwriters and their counsel to structure the underwriting compensation for a public offering in compliance with the underwriting compensation limitation of Rule 5110 prior to filing with FINRA.

Modify the Standard for the Filing of Amended Documents

The Rule Proposal would modify the document filing requirements in proposed Rule 5110(a)(4)(A)(iii) to only require the filing of an amendment to a previously-filed document if there are "changes to the offering and the underwriting terms and arrangements . . . ." I anticipate that most changes to a registration statement and related documents could be viewed as either related to the offering or underwriting terms and arrangements. Moreover, any effort by FINRA to explain when an amendment is deemed to be a change to the offering will be likely be unsuccessful because counsel will generally prefer to err toward over-filing.

Therefore, to the extent that FINRA intended to limit the filing of amendments to changes relevant to the requirements of the FINRA underwriting rules, this is to recommend that FINRA modify the proposal to limit the requirement to file amended documents to situations where there are:

…..<u>changes that may affect the underwriting terms and arrangements</u>.

Revise the Standard Used for Determining When Straight Debt and Derivative Securities are Underwriting Compensation

The proposed definition of "underwriting compensation" in Section (i)(22) of the Rule Proposal would limit underwriting compensation to "any payment, right, interest, or benefit . . . for underwriting, allocation, distribution, advisory, and other investment banking services in connection with a public offering." However, in the case of non-convertible and non-exchangeable debt ("straight debt") and derivative instruments, the Proposed Rule would continue to loos to whether the securities were acquired in a transaction "related to the public offering."[8] The Rule Proposal does not include an explanation of the terms "related to the public offering" or "unrelated to the public offering," which are used in many provisions of the Rule Proposal.[9] Thus, the use of the concept of these terms is confusing.[10]

It appears more appropriate to solely treat such securities as underwriting compensation if not aquired at a "fair price" or to apply the standards in the definition of "underwriting compensation." As discussed below, I also recommend that straight debt securities be entirely excluded from underwriting compensation.

Exempt Straight Debt Securities From Underwriting Compensation

I do not believe that there is any investor protection purpose for treating straight debt securities as underwriting compensation due to the nature of the instrument that makes it unlikely to be used as a "payment . . . for investment banking services." In order to further modernize Rule 5110 consistent with investor protection, this is to request that FINRA consider at this time excluding straight debt securities from being treated as underwriting compensation.[11]

The Proposed Limited Exemption for Straight Debt: The Rule Proposal would modify the current exemption from underwriting compensation for straight debt (and derivative) instruments in proposed Supplementary Material .01(b)(19) by removing the "fair price" and "ordinary course of business" requirements and solely exclude such securities acquisitions if deemed acquired in a transaction that is "unrelated to the public offering."[12]

---

[8] In addition, proposed Section 5110(a)(4)(B)(v)a. and b. use the term "related to the public offering" as the criteria for determining when information is required be filed regarding the acquisition of straight debt and derivative instruments.

[9] Other instances where the term "unrelated" to an offering is used to determine whether an item of value will be included in underwriting compensation are found in proposed Supplementary Material .01(b as follows: "(b) Participating members may receive payments from an issuer or another source during the review period that may be unrelated to a particular offering. Such payments generally would not be deemed to be underwriting compensation." This is to recommend that this provision be revised as follows: "(b) Participating members may receive payments from an issuer or another source during the review period that ~~may be unrelated to a particular offering. Such payments~~ generally would not be deemed to be underwriting compensation."

[10] An acquisition of straight debt securities by a participating FINRA member may be "related" to a public offering because (for example) the securities are issued to raise capial for operating or offering expenses and, yet, not be for the purpose of obtaining a payment for investment banking services. Moreover, there a debt-equity exchange structure in which participating FINRA members acquire the issuer's debt securities, which then may deemed to be underwriting compensation because the debt securities do not have a public market. And there are a number of offering structures involving derivatives, such as interest-rate swaps.

[11] Since I have difficulty identifying a scenario where a participating FINRA member would negotiate advantageous terms for the purchase of debt securities in order to obtain additional underwriting compensationt, the experience of the FINRA Corporate Financing Department would be instructive on the problematic situations that may require continued regulation of straight debt securities purchases.

[12] As previously stated, this standard is different than that set forth in the definition of "underwriting compensation." If an alternative standard is necessary, it appears more appropriate to exclude such instruments from underwriting compensation if acquired at a "fair price."

Straight Debt is a Securitized Loan: I believe that straight debt should be treated under the Corporate Financing Rule in the same manner as a loan. Loans are often provided by a participating member or its affiliate to an issuer in the case of an IPO in order to assist the issuer to cover the considerable expenses of going public or to finance operations in the period before the IPO.

Since the repeal of the Glass-Steagall Act (adopted as part of the Banking Act of 1933 to separate commercial and investment banking) in 1999, a bank or other affiliate of one or more participating FINRA members will often have entered into a line of credit or loan with a company proposing to conduct an IPO or follow-on public offering of securities. Even though it could be argued that certain of such loans are "related to the public offering," the interest and fees received during the review period by the participating FINRA member and any of its affiliates for a loan to an issuer are not treated as underwriting compensation under the Corporate Financing Rule.[13]

Since a straight debt instrument is simply a securitized loan by multiple lenders to a borrower, I believe it is inconsistent to continue to include straight debt securities in underwriting compensation.[14]

Recommendation: This is to recommend that FINRA exempt the purchase of straight debt securities from underwriting compensation by amending Supplementary Material .01(b) to adopt a separate exemption for non-convertible or non-exchangeable debt securities without the caveate that such acquisition must be unrelated to the public offering.

To the extent that FINRA determines, nonetheless, to continue to treat straight debt as underwriting compensation, this is to recommend that FINRA adopt a more narrow exception from underwriting compensation for straight debt securities purchased at par (if the purchaser is the sole purchaser) or purchased at least at the same price as other purchasers at or about the same time for the same issue of debt (referred to hereafter as the "Straight Debt Valuation Method"). When such securities are purchased at a "fair price" using an objective method of valuation, there appears to be no investor protection benefit to including such securities in underwriting compensation.

Clarify the Valuation of Debt Securities Deemed To Be Underwriting Compensation

If, despite the recommendation set forth above, FINRA continues to treat straight debt securities as underwriting compensation, FINRA should revise how such debt securities are to be

[13] The sole situation where a loan is related to the underwriting compensation requirements is when the lender receives fees in the form of equity or equity-linked securities.

[14] *See also* related comments below regarding the valuation of straight debt securities and the application of the Lock-Up Restriction to straight debt securities.

valued under proposed Rule 5110, Supplementary Material .04.[15] Supplementary Material .04 states that straight debt (and derivative) securities acquired in a transaction related to the public offering that are purchased at a "fair price" will have no compensation value, but does not set forth an objective method for determining the "fair price." The provision further states that straight debt securities not acquired at a "fair price" in a transaction related to the public offering will be valued using a method that the FINRA member should describe in its submission to FINRA.

Because Supplementary Material .04 does not provide an objective method for determining the "fair price" or other value of straight debt instruments it is likely that counsel will often engage in unnecessarily drawn-out exchanges with FINRA staff on the appropriate valuation method to use.

This to recommend that proposed Supplementary Material .04 be revised to provide that straight debt securities determined to be underwriting compensation shall be valued using the Straight Debt Valuation Method discussed above.[16] This formula would provide an objective methodology for valuation that is appropriate to straight debt instruments that is consistent with investor protection.

Clarify the Valuation of Certain Equity Securities

The proposed valuation provisions in Rule 5110, Supplementary Material .02 would continue to provide two methods for valuation of equity securities deemed to be underwriting compensation depending on whether the securities are "non-convertible" or are "options, warrants and other convertible securities."

Clarify the Valuation of Unit Securities: However, the current Corporate Financing Rule and proposed Supplementary Material .02 do not identify how unit securities should be valued. Unit securities generally contain one or more shares of common stock and a warrant for some amount of common stock. Following the public offering of units, the unit security sold in the public offering will usually initially trade on a national securities exchange for a number of days and, thereafter, will split into its components so that the common stock and warrant will trade separately.

In the case of such public offerings of units, it is not unusual that securities acquired by a participating FINRA member in a private placement within the review period will also be structured as units with substantially the same terms as the publicly offered units (although at

[15] This provision also addresses the valuation of derivative securities.

[16] Although it is possible that the same series of debt securities may later be sold by the issuer in its public offering at a price that is above par or the price paid by the participating FINRA member, that premium would likely result from the independent impact of current interest rates on the public offering price. However, the publicly offered debt and the debt purchased by the participating FINRA member are more likely to be a different series of debt and, thus, not comparable for purposes of valuation.

times the private placement units and securities contained therein will have more restrictive terms than the public units and securities contained therein). Because the unit contains a warrant, it is not clear how the unit should be valued pursuant to current Rule 5110 and in accordance with proposed Supplementary Material .02. Unlike the stock exchanges that will list the unit for trading, it has appeared at times that it is FINRA policy to "look-through" the unit to value the individual components and ascribe an additional value to the warrant within the unit even though the purchaser may have paid the same price for the unit as the public offering price.

I believe that such a unit security should be valued as a non-convertible security under the valuation provisions because the unit is, in fact, a security that does not itself have an exercise or conversion price. Therefore, when a participating FINRA member acquires a non-convertible unit at the same price as the public offering price of the unit, such unit securities should have a zero valuation and should not be ascribed an additional value because they contain a warrant since the public is receiving the same warrant and, therefore, the same potential benefit that results from such warrant.

Include a Valuation Method for Securities With a Public Market: Supplementary Material .02 does not include an alternative method for valuing securities that have a public market at the time of purchase as is available in current Rule 5110(e)(2)(A). Thus, such securities would be required to be valued at the difference between the purchase and the public offering price ("POP") in the case of a follow-on offering of securities. The Notice does not address why this change was proposed.

Recommendation: This is to recommend that Supplementary Material .02 be revised as follows:

> The value of non-convertible securities (including units composed of common stock, warrants or other securities that are substantially the same as those being offered to the public) received as underwriting compensation will have a compensation value based on the difference between (i) either the public offering price per security or, if a *bona fide* independent market exists for the security, the market price per security on the date of acquisition; and (ii) the per security cost.[17]

Clarify Whether the Current Warrant Formula is an Acceptable Security Valuation Method

The Rule Proposal would eliminate a mathematical formula in current Rule 5110(e)(3) (the "warrant forumula), which has been the required method under the Corporate Financing Rule for valuing securities that have an exercise or conversion price. Instead, FINRA would permit FINRA members to rely on any securities valuation method that is commerciall available and is appropriate for the type of securities to be valued and require the filing of a description of the methodology with FINRA. I support this proposal but request a clarification.

---

[17] In addition, it is my understanding

Although the warrant formula is being eliminated, there are situations where the warrant formula may continue to be a viable method for valuing securities. This is to recommend that FINRA advise whether, as a matter of policy, it will continue to accept the warrant forumula as a *bona fide* valuation method for securities that have an exercise or conversion price.

Reinstate the Current Scope of the Lock-Up Restriction

Introduction: I support the proposed revision to the lock-up requirement in proposed Rule 5110(d) (the "Lock-Up Restriction") that would once again only apply the Lock-Up Restriction to securities that are deemed to be underwriting compensation. However, I do not support other proposed changes to the Lock-Up Restriction that would expand its application to:

1. straight debt securities deemed to be underwriting compensation;
2. securities deemed to be underwriting compensation in offerings of debt securities; and
3. registered securities.

Perhaps this expansion was unintentional as there is no discussion of these material changes in the Notice. Nonetheless, in the event that the change was intentional, following are my comments.

Rationale for the Lock-Up Restriction: The primary purposes of the Lock-Up Restriction are to allow the public market for the issuer's equity securities to develop prior to a participating member selling their underwriting compensation securities into the public market and to address any incentive for fraud in the development of the aftermarket. Thus, the prohibition was apparently intended to address investor protection concerns that would tend to arise only in the context of an issuer's IPO or where the issuer's equity securities had a thin trading market.

Reinstate Limitation to Equity and Equity-Linked Securities: As previously discussed, any straight debt securities that are included in the calculation of underwriting compensation: (1) are likely a different issue or series than those sold to the public and will not have a public market; and (2) even if the securities are from the same issue, the public secondary market trading price of such debt instruments is primarily determined by fluctuating interest rates rather than the types of market forces that affect the equity markets. Therefore, consistent with FINRA's objective to modernize the Corporate Financing Rule, this is to recommend that straight debt securities deemed to be underwriting compensation should be excluded from the Lock-Up Restriction as there is no investor protection benefit that would be achieved.

Reinstate Limitation to Equity Offerings: There is no indication in the Notice that FINRA has identified an investor protection rationale for extending the Lock-Up Restriction to public offerings of debt when a participating FINRA member has received equity securities as underwriting compensation. In some cases, the equity securities will not have a public trading market. Where there is a public market in such equity securities, that market will be generally be unaffected by the issuer's debt offering. Thus, the Lock-Up Restriction should continue to only apply to securities deemed underwriting compensation in the case of public offerings of equity securities.

Reinstate Limitation to Unregistered Securities: There is no guidance in the Notice as to why FINRA is proposing to apply the Lock-Up Restriction to registered securities. Therefore, this is to request that FINRA reconsider whether there is any investor protection objective achieved by this expansion of the Lock-Up Restriction

Recommendation: Based on the foregoing, this is to recommend that FINRA revise the proposed Lock-Up Restriction in proposed Rule 5110(d) to state that the restriction, as it does currently, only applies in the case of a public equity offering to common or preferred stock, options, warrants, and other equity securities, including debt secuities convertible to or exchangeable for equity securities of the issuer, that are unregistered.

Modify the Lock-Up Restriction Period for Follow-On Offerings

While the 180-day lock-up in the case of an IPO continues to be consistent with the industry practice that limits the resale of equity securities by the officers, directors and insiders of the issuer following the IPO, this is to recommend that the Lock-Up Restriction be shortened in the case of a follow-on offering of equity securities.

In consideration of the market dynamics that generally result from after-market stabilizing and covering transactions by the managing underwriter, FINRA may wish to consider that the Lock-Up Restriction for follow-on offerings should be as long as the contracted term of the overallotment option (which would thereby serve as an objective standard), which generally is 30 days but may be as long as 45 days, or 30 days following the commencement of sales in the event there is no overallotment option (as in the case of a "best-efforts" underwritten offering).

Expand the Exemption for Securities Acquired Through Section 401 Qualified Plans

Proposed FINRA Rule 5110, Supplementary Material .01(b)(12) would incorporate the current exemption from underwriting compensation for securities acquired by an underwriter and related person through any stock bonus, pension, or profit-sharing plan ("employer plan") that qualifies under Section 401 of the Internal Revenue Code ("IRC") (the "Exemption"). This Exemption is proposed to be adopted with the addition of the words "or a similar plan."

Increasingly, there have been offerings where securities were acquired by associated and affiliated persons of a participating member through a *bona fide* employer plan that was not, however, formed in compliance with the tax-advantaged provisions of Section 401. These securities acquisitions (1) did not raise investor protection concerns; (2) occurred in the normal course of the persons' employment or in the ordinary course of business; and (3) were not in anticipation of participating in any underwritten offering or with any intent to persuade a FINRA member to underwrite an offering.[18]

[18] Certain of the situations where this issue has occurred will be addressed by FINRA's proposal to exclude the "issuer" from the definition of "participating member." However, other situations would benefit from a case-by-case determination by FINRA staff. *See* comment regarding these definitions below.

I support an amendment that would permit FINRA staff to consider on a case-by-case basis excluding securities from underwriting compensation that are granted under other types of employer plans that are not formed pursuant to IRC Section 401. However, I am unable to support this amendment as proposed because it could be interpreted now or far in the future to require that the "similar" employee plan be another type of IRS tax-advantaged employee plan or that the plan must have terms that are similar to those of an IRC Section 401 plan, although this narrow scope may not have been intended by FINRA.

With the caveat that I am not a tax law expert, my research indicates that there are no other relevant IRS tax-advantaged employee plans that an issuer may establish that would result in the issuance of securities that would be treated as underwriting compensation under Rule 5110.[19] A Section 401 plan must satisfy a number of IRC requirements, including that the plan "not discriminate in favor of highly compensated employees," *i.e.,* the plan must be available to all employees. Section 401 plans are subject to ERISA reporting, disclosure and fiduciary responsibility requirements. Although Section 401 allows for the creation of a stock bonus, pension, or profit-sharing plan, a typical Section 401 plan is structured under Section 401(k) as a pension plan that allows the issuer and employee to make tax-deductible contributions to the plan for the purpose of purchasing securities. Thus, Section 401 plans cannot be formed as a stock compensation or incentive plan, cannot benefit company directors, and are usually formed only for a stock pension plan.

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.[20] 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.

This is to recommend that FINRA revise the proposed Exemption as follows in order to extend the exemption to other types of *bona fide* employee and director plans:

> compensation received through any stock bonus, pension, or profit-sharing plan that qualifies under Section 401 of the Internal Revenue Code or, as determined on a case-by-case basis, compensation received through any other type of written plan that was initially established in the ordinary course of business.

---

[19] For example, IRC Section 422 allows a company to grant incentive stock options to employees (not stock incentives that are not options), so that the employee is exempted from paying ordinary income tax on the difference between the option exercise price and the fair market value of the shares. In addition, IRC Section 423 permits companies to use employee stock purchase plans to allow their employees to make discounted purchases of employer securities by exercising options at regular intervals.
[20] Many public companies will also establish such non-tax-qualified plans in addition to an IRC Section 401(k) pension plan.

The generic reference to "any other type of plan" in the above proposed change to the Exemption is intended to cover any cash or stock compensation, bonus, pension and incentive or profit-sharing plan.

Revise the Definitions of "Participating Member" and "Issuer"

While I agree with the proposal to exclude the "issuer" category from the definition of "participating member," the addition of the words "other than the issuer" at the end of the definition does not make it clear that the issuer, as defined in Rule 5110, is exempted from all of the categories of a "participating member" rather than just from the category of "immediate family." Therefore, this is to request that FINRA replace the words "other than the issuer" with:

> …..; provided, however, that the term "participating member" shall not include the "issuer."

In order to completely address the practical problems that occur when a person or entity is within both the definitions of "issuer" and "participating member," this is to also recommend that FINRA amend the definition of "issuer" to similarly exclude "any participating member" from the definition consistent with the form of the recommendation in the prior paragraph.

Request for Comment on Need for a Stock Numerical Limitation

In the Notice, FINRA requests comment on whether a form of Stock Numerical Limitation should be reinstated. I believe it is likely that a Stock Numerical Limitation would create more unnecessary problems than it would resolve unless limited to the types of securities that present investor protection concerns.

Background: Since the Stock Numerical Limitation was eliminated as part of the 2004 amendments to the Corporate Financing Rule, it may be helpful to review the purpose and operation of the Stock Numerical Limitation as I understand these matters. In general, the Stock Numerical Limitation was originally intended to ensure that the underwriters as a group could not acquire a disproportionate amount of the issuer's securities, regardless of whether the other terms and arrangements were in compliance with the Corporate Financing Rule. Therefore, "underwriters and related persons," in the aggregate, were limited to acquiring or receiving as underwriting compensation securities in excess of 10 percent of the securities sold in the public offering (without including the overallotment option).

The Stock Numerical Limitation operated effectively in an era when commercial and investment banking institutions were not affiliated and securities acquired as underwriting compensation securities were almost always in the form of "underwriter's warrants" (warrants that were granted to the underwriters as part of the formal underwriting compensation arrangement with the issuer) and pre-filing private placement stock purchases. While stock purchases were effectively limited by the inclusion of the value of the stock in underwriting compensation as well as the Stock Numerical Limitation, acquisitions of warrants were and remain more problematic.

At that time and currently, when underwriter's warrants have an exercise price that is 165 percent of the POP, the application of the current warrant valuation formula in Rule 5110(e)(3) results in a zero valuation regardless of the number of securities underlying the warrants. Currently, Rule 5110(e)(3)(H) places a limit on the amount of securities by applying a minimum valuation to securities that have an exercise or conversion price (the "Minimum Value provision").[21] Therefore, when warrants are valued at zero, absent compliance with the prior Stock Numerical Limitation or the current Minimum Value provision, the underwriter would be able to obtain warrants for any amount of the issuer's securities. The only remaining "restriction" on the underwriter benefiting financially from such warrants and becoming a major shareholder of the issuer is if the market price of the issuer's securities failed to rise above 165% of the POP during the five-year period that such warrants may be exercised pursuant to Rule 5110(f)(2)(G).[22]

The Current Dynamics of Acquisitions of Underwriting Compensation Securities: With the elimination of the Glass-Steagall Act, as referenced above, FINRA amended Rule 5110 in 2004 ". . . to ensure that the Rule would accommodate the modern, legitimate corporate financing activities of members, while protecting issuers and investors from unreasonable or coercive practices."[23] The Rule Proposal indicates that FINRA remains committed to regulating underwriting compensation in a manner that does not prevent FINRA members and their affiliates from continuing to provide a variety of services to their corporate financing clients, including loans to and venture-type investments in the issuer. Consistent with the foregoing FINRA should not now impose a Stock Numerical Limitation in a manner that would artificially restrict such permissible venture, lending and other services that benefit corporate financing clients.

Moreover, any numerical restriction on private placement purchases by a FINRA member and its affiliates of the securities of the issuer would be contrary to the interests of issuers that often look to the FINRA members that will participate in its public offering to also purchase a significant portion of any pre-IPO private placement. Similarly, the customers of such FINRA members that purchase pre-IPO private placement securities generally expect that the FINRA member will share the risk of the investment by being a co-investor. With respect to securities acquired in venture and lending activities where the participating FINRA member must make a significant financial investment, the underwriting compensation guideline has and will effectively continue to limit the amount of securities acquired as underwriting compensation.

Recommendation to Limit any Stock Numerical Limitation to Underwriter's Warrants: However, in the case of underwriter's warrants, the underwriting compensation guideline will not necessarily be effective in restricting the amount of securities when it is possible that to

---

[21] This provision indirectly limits the amount of securities that could potentially be acquired by an underwriter through the underwriting compensation limitation. The Rule Proposal does not include a similar provision that would ascribe a minimum value to warrants and similar securities.

[22] This provision is proposed to be retained in proposed Rule 5110(f)(7).

[23] NASD Notice to Members 04-13 (February 2004), at 114.

structure the warrants with a high exercise price so that the warrant valuation is zero or close to zero.

Therefore, to the extent that FINRA does not identify another method to address the amount of underwriter's warrants, this is to recommend that FINRA adopt a Stock Numerical Limitation applicable in the aggregate to all participating FINRA members of 15 percent[24] only with respect to a narrow category of stand-alone grants of underwriter's warrants by the issuer. Thus, such a limitation should not apply in the case of warrants purchased for a "fair price," or that are granted in association the purchase of common stock or any other security, a loan, or a credit facility, and other situations where the FINRA member has undertaken significant financial risk.

* * * *

I appreciate the opportunity afforded by FINRA to submit these comments on significant proposed amendments to the Corporate Financing Rule. If you require further information regarding these comments, please contact the undersigned.

Very truly yours,

Suzanne Rothwell

Suzanne Rothwell
Managing Member

[24] The 15 percent number is recommended in light of the restriction on the exercise period of such warrants and that the limitation is applied in the aggregate to all participating members.