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Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. SR-FINRA-2019-012 (Proposed Rule Change to Amend FINRA Rule 5110 (Corporate Financing Rule - Underwriting Terms and Arrangements) to Make Substantive, Organizational and Terminology Changes)

Dear Ms. Countryman:

This letter responds to comments received by the Securities and Exchange Commission (“SEC” or “Commission”) to the above-referenced rule filing (the “Proposal”) related to making substantive, organizational and terminology changes to FINRA Rule 5110 (Corporate Financing Rule - Underwriting Terms and Arrangements) (“Rule”). The Proposal is intended to modernize Rule 5110 and to simplify and clarify its provisions while maintaining important protections for market participants, including issuers and investors participating in offerings. The Proposal would also update cross-references and make other non-substantive changes within FINRA rules due to the proposed amendments to Rule 5110.

The Commission published the proposed rule change for public comment in the Federal Register on May 1, 2019,¹ and received six comments in response to the Proposal.² Four commenters supported FINRA’s efforts to review, streamline and modernize the Rule for the benefit of market participants but offered suggested modifications as to some aspects of the Proposal.³ CAI supported a proposed

¹ See Securities Exchange Act Release No. 85715 (April 25, 2019), 84 FR 18592 (May 1, 2019) (Notice of Filing of File No. SR-FINRA-2019-012).

² See Partial Amendment No. 1 for a list of comments received and abbreviations assigned to commenters.

³ See ABA, Davis Polk, Rothwell and SIFMA.

exemption, but did not comment on other aspects of the Proposal. Kaswell did not support Rule 5110's requirements and stated that excessive underwriting compensation should be addressed through disclosure to investors. On July 11, 2019, FINRA responded to the comments and filed Partial Amendment No. 1 to the Proposal to propose amendments to Rule 5110 based on the comments received by the Commission.⁴

The Commission published a notice and order to solicit comments on the Proposal as modified by Partial Amendment No. 1 and to institute proceedings to determine whether to approve or disapprove the proposed rule change, as modified by Partial Amendment No. 1.⁵ The Commission received three comment letters following the publication of the Order Instituting Proceedings.⁶ The following are FINRA's responses, by topic, to the commenters' material concerns.

Filing Requirements

The Proposal would amend Rule 5110's filing requirements to create a process that is both more flexible and more efficient for members.

SIFMA stated that filing a merger and acquisition ("M&A") or private placement stand-alone engagement letter with FINRA should not be required unless the letter contains provisions that relate to the underwriting terms and arrangements for the public offering under review (*e.g.*, provisions for an ongoing right of first refusal ("ROFR")) or otherwise provides for securities-based compensation that may be deemed underwriting compensation for the public offering under review.

Rule 5110 requires filing with FINRA documents that impact the underwriting terms and arrangements for the public offering, such as financing terms. Proposed Rule 5110(a)(4)(A)(ii) requires filing an engagement letter with FINRA for review when the engagement letter contains terms relevant to the underwriting terms and arrangements of the public offering being reviewed pursuant to Rule 5110. If the proposed rule change is approved, FINRA's electronic filing system for public offerings will be revised and FINRA staff will administer the rule consistent with

⁴ See Letter from Jeanette Wingle, Associate General Counsel, FINRA, to Vanessa Countryman, Secretary, SEC (July 11, 2019) ("Response Letter No. 1").

⁵ See Securities Exchange Act Release No. 86509 (July 29, 2019), 84 FR 37921 (August 2, 2019) (Order Instituting Proceedings To Determine Whether To Approve or Disapprove SR-FINRA-2019-012) ("Order Instituting Proceedings").

⁶ See Partial Amendment No. 2 for a list of comments received and abbreviations assigned to commenters to the Order Instituting Proceedings.

proposed Rule 5110(a)(4)(A)(ii). Filing of engagement letters that do not contain terms relevant to the underwriting terms and arrangements of the public offering being reviewed pursuant to Rule 5110 would not be required. For example, a stand-alone M&A letter whose terms are unrelated to the public offering being reviewed pursuant to Rule 5110 would not be required to be filed.

With respect to the representation requirement in proposed Rule 5110(a)(4)(B)(iii) where beneficial owners of 5 percent or more of any class of the issuer's equity securities are funds or other types of investment vehicles, SIFMA suggested in response to the Proposal and the Order Instituting Proceedings requiring a statement of association or affiliation only with respect to the general partner or investment manager of a fund or investment vehicle, and any limited partner beneficially owning more than 25 percent of the limited partnership or limited liability company membership interests of the fund or investment vehicle. SIFMA suggested that the approach would balance FINRA's interest in gathering information about potential conflicts with the difficulties in obtaining information as to limited partners who have no investment discretion or control over the fund's investments.

FINRA previously considered this issue in responding to comments received to the Regulatory Notice 17-15 (April 2017) ("Notice 17-15 Proposal") and in Response Letter No. 1. As previously discussed, although application of Rule 5110's requirements to beneficial ownership by funds or other types of investment vehicles historically has not been problematic, there have been some instances where conflicts have been identified. However, FINRA now believes that Rule 5110 may be amended to provide greater flexibility to participating members in relation to beneficial ownership information while still requiring that participating members provide information needed to identify potential conflicts of interest. FINRA Rule 5121 (Public Offerings of Securities With Conflicts of Interest) defines "control" as, among other things, beneficial ownership of 10 percent or more of an entity's common or preferred equity. FINRA proposes to amend the threshold in proposed Rule 5110(a)(4)(B)(iii) from 5 percent to 10 percent for consistency with the approach in Rule 5121.⁷

Disclosure

The Proposal would retain Rule 5110's current requirements for itemized disclosure of underwriting compensation and disclosing dollar amounts ascribed to

⁷ Specifically, as discussed in Partial Amendment No. 2, FINRA is proposing to revise proposed Rule 5110(a)(4)(B)(iii) to requiring filing "a representation as to whether any officer or director of the issuer and any beneficial owner of [5%] 10% or more of any class of the issuer's equity and equity-linked securities is an associated person or affiliate of a participating member;"

each item.⁸ The Proposal also would incorporate the requirements for disclosure of specified material terms and arrangements that are consistent with current practice.⁹ SIFMA disagreed with this approach and stated that itemized disclosure of individual dollar amounts is not necessary or helpful to investors if the amount is immaterial in the context of the transaction. SIFMA suggested adopting a *de minimis* exception for itemized disclosure under which participating members may disclose a maximum aggregate value for items of underwriting compensation that do not individually or in the aggregate exceed the lesser of: (1) \$50,000; and (2) 0.1 percent of the dollar amount of securities offered in the public offering. SIFMA suggested that a *de minimis* exception would not allow a participating member to divide compensation amounts into smaller buckets to avoid the itemized disclosure requirement and that such an exception is appropriate for certain smaller items of compensation that do not, individually or when aggregated together, reasonably present investor protection concerns.

The Notice 17-15 Proposal would have modified Rule 5110's underwriting compensation disclosure requirements. Although a description of each item of underwriting compensation would have been required to be disclosed, the Notice 17-15 Proposal would have no longer required that the disclosure include the dollar amount ascribed to each individual item of compensation. Rather, the Notice 17-15 Proposal would have permitted a member to disclose the maximum aggregate amount of all underwriting compensation, except the discount or commission that must be disclosed on the cover page of the prospectus.

FINRA is no longer proposing to eliminate the itemized disclosure that Rule 5110 currently requires. As previously discussed in the Proposal and in Response Letter No. 1, commenters had conflicting views on the proposed change to allow aggregation of underwriting compensation with one commenter stating that the itemized disclosure may be beneficial for investors in better understanding the underwriting compensation paid and incentives that may be present in the public offering. Recognizing commenters' conflicting views, the Proposal would retain the current requirements for itemized disclosure of underwriting compensation and disclosing dollar amounts ascribed to each such item and would incorporate the requirements for disclosure of specified material terms and arrangements that are consistent with current practice.

A *de minimis* exception would inherently involve a participating member categorizing different forms of underwriting compensation and determining whether

⁸ See proposed Rule 5110(b)(1) and Supplementary Material .05 to Rule 5110. See also proposed Rule 5110(e)(1)(B) requiring disclosure of lock-ups.

⁹ See proposed Supplementary Material .05 to Rule 5110.

the specific category exceeds the *de minimis* threshold. FINRA continues to believe that the current itemized approach to disclosure is appropriate.

SIFMA also suggested that nominal gifts and occasional meals or other business entertainment that are provided in accordance with the limits set forth in proposed Rule 5110(f)(2)(A) and (B) should not be required to be separately itemized and disclosed as underwriting compensation. SIFMA contended that this would be a new requirement and the administrative burdens and costs that would be placed on member firms in an attempt to achieve technical compliance with the literal terms of the requirement are not justified. FINRA previously considered this issue in responding to comments in Response Letter No. 1. Consistent with FINRA's proposal to retain the current approach to disclosing underwriting compensation, the proposed rule change would not alter the current requirements for disclosing non-cash compensation. Non-cash compensation in connection with a public offering has long been considered underwriting compensation under Rule 5110 and is disclosed to FINRA via a question in FINRA's electronic filing system for public offerings. Moreover, Item 508(e) of the SEC's Regulation S-K has long required disclosure in the offering document of any item deemed underwriting compensation under FINRA rules.

Kaswell stated that Rule 5110's restrictions on underwriting compensation in public offerings impose a burden on competition that is not consistent with the Securities Exchange Act of 1934 ("Exchange Act") and is inconsistent with the purposes of the Securities Act of 1933 ("Securities Act"). Callcott stated that Rule 5110 imposes a tax on capital formation and is anti-competitive as underwriters compete among themselves to provide financing to issuers but also with banks, non-banks and the private markets. To the extent that Rule 5110 causes issuers to obtain financing from banks and non-banks or from the private markets, Callcott stated that the competitive position of the latter is enhanced and that of underwriters is diminished. Callcott and Kaswell supported eliminating Rule 5110 entirely or amending it to require only disclosure of underwriting compensation to investors.

FINRA previously considered this issue in responding to comments to the Notice 17-15 Proposal and in Response Letter No. 1. As previously discussed, disclosure of underwriting compensation is an important component of Rule 5110. While disclosure is valuable to investors in assessing public offerings, additional protections are needed to govern underwriting terms and arrangements. Rule 5110 continues to play an important role in ensuring investor protection and market integrity through effective and efficient regulation that facilitates vibrant capital markets.

The primary function of Rule 5110 is to protect issuers and their investors at the time of the public offering from unfair underwriting terms and arrangements. Issuers have different bargaining power and experience with capital raising. Removing Rule 5110's restrictions on underwriting terms and arrangements would remove important protections for issuers and investors. For example, such an

approach would eliminate Rule 5110's lock-up restrictions, thereby permitting underwriters to sell their shares before other insiders. Moreover, the lock-up restrictions are an important protection to align the interests of the underwriters with those of the investors in the offering.

Such an approach would also eliminate Rule 5110's list of prohibited terms and arrangements in connection with a public offering of securities. For example, Rule 5110(g)(4) prohibits receiving underwriting compensation prior to the commencement of sales, subject to listed exceptions. This restriction is important because it expressly prohibits an underwriter from receiving underwriting compensation from an issuer where a public offering is not completed and the issuer receives no financing (*e.g.*, an issuer who is a poor candidate for a public offering).

In a comment letter to the Notice 17-15 Proposal supporting a disclosure-only approach, Callcott stated that because "troubled" public companies present the highest liability risks for underwriters, underwriters are unwilling to assist the companies unless they are adequately compensated for the risk. Due to Rule 5110's restrictions on underwriting terms and arrangements, Callcott said that these "troubled" companies instead seek alternative financing. The commenter again suggests that imposing restrictions on underwriting terms and arrangements is disadvantageous to underwriters as underwriters are not free to set terms without any regulatory restrictions. While removing Rule 5110's restrictions would allow an underwriter wide latitude in setting underwriting terms and arrangements, it remains unclear how removing Rule 5110's restrictions on underwriting terms and arrangements would be a net positive for issuers and investors. An issuer who is a poor candidate for a public offering may need to seek alternative financing, and allowing an underwriter to set unfair terms and arrangements to encourage a public offering may lead to an inefficient use of capital, redistributing investor funds from the issuer to the underwriter.

Venture Capital Exceptions

Recognizing that bona fide venture capital transactions contribute to capital formation, the Proposal would modify, clarify and expand the current venture capital exceptions to further facilitate members' participation in bona fide venture capital transactions. Importantly, the venture capital exceptions would include several restrictions to ensure the protection of other market participants and that the exceptions are not misused to circumvent the requirements of Rule 5110.

SIFMA suggested providing that the determination as to the availability of a venture capital exception is to be made by the participating member at the time of the acquisition of the securities and based on the participating member's knowledge at that time. FINRA previously considered this issue in responding to comments received to the Notice 17-15 Proposal and in Response Letter No. 1. Except for the principles-based approach for significantly delayed offerings, FINRA has historically interpreted the venture capital exceptions to provide that the determination of whether

a securities acquisition qualifies under an exception is to be made before the required filing date. While this approach provided flexibility for participating members in assessing whether the requirements for a venture capital exception were met before the required filing date, SIFMA has suggested greater certainty by determining whether a securities acquisition meets a venture capital exception at the time of the acquisition.

To provide the requested certainty, FINRA proposes to interpret the venture capital exceptions to provide that the determination of whether a securities acquisition qualifies under an exception is to be made at the time of the acquisition. As discussed in Partial Amendment No. 2, FINRA is proposing new Supplementary Material .07 to Rule 5110 to expressly state this interpretation.¹⁰ FINRA would consider what the participating member knew, or reasonably should have known, at the time of a securities acquisition in assessing whether the securities acquisition may be excluded from underwriting compensation pursuant to paragraph (d). As SIFMA noted, a securities acquisition must be made prior to the required filing date to qualify for the venture capital exceptions. Accordingly, proposed Rule 5110(d)(1)-(4) would retain the language “before the required filing date of the public offering” in the rule text to continue to require that the securities acquisition be made prior to the required filing date to qualify for a venture capital exception.

Defined Terms

In addition to consolidating the defined terms in one location at the end of the Rule, the Proposal would simplify and clarify Rule 5110’s defined terms. The Proposal would make the terminology more consistent throughout the Rule’s various provisions.

As suggested by the ABA in its comment to the Proposal, FINRA proposed in Partial Amendment No. 1 to amend the proposed definition of bank in proposed Rule 5110(j)(2) to mean “a bank as defined in Section 3(a)(6) of the Exchange Act, a branch or agency in the United States of a foreign bank that is supervised and examined by a federal or state banking authority and otherwise meets the requirements of Section 3(a)(6) of the Exchange Act, or [is] a foreign bank that has been granted an exemption under this Rule and shall refer only to the regulated entity, not its subsidiaries or other affiliates.” As the ABA noted, this approach is consistent with the SEC’s interpretation of what is a bank for other purposes under the federal securities laws. For example, the SEC provided that for purposes of Rule 15a-6 under

¹⁰ Specifically, as discussed in Partial Amendment No. 2, proposed new Supplementary Material .07 to Rule 5110 would state “[t]he determination of whether a securities acquisition may be excluded from underwriting compensation pursuant to paragraph (d) is to be made at the time of the securities acquisition.”

the Exchange Act, a foreign bank is excluded from the defined term “bank” except to the extent that the “foreign bank establishes a branch or agency in the United States that is supervised and examined by a federal or state banking authority and otherwise meets the requirements of section 3(a)(6).”¹¹

SIFMA agreed with the proposed modification to the definition of bank but suggested that proposed Rule 5110(h)(1)(A) also be amended to include “foreign bank” to avoid creating a new and burdensome requirement that foreign banks must apply to FINRA for an exemption before relying on the investment grade debt exemption from filing. FINRA has historically interpreted the investment grade debt exemption to apply to qualifying securities offered by a bank; however, the lack of a specific reference to bank securities in the rule text has raised questions by members. By modifying the proposed definition of bank, FINRA did not intend to alter the availability of the investment grade debt exemption for foreign banks with qualifying securities. Accordingly, FINRA proposes to amend proposed Rule 5110(h)(1)(A) by adding “foreign bank” to the list of entities that may rely on the exemption.

SIFMA expressed concern that the proposed defined term “experienced issuer” would eliminate the SEC and FINRA history and interpretive guidance that accompany the Form S-3, F-3 and F-10 eligibility requirements. SIFMA requested additional clarification regarding whether member firms can rely on prior SEC and FINRA guidance and interpretation, including related to determining aggregate market value and public float.

FINRA considers any guidance and interpretation, including, but not limited to, any guidance and interpretation on determining aggregate market value and public float, issued by the SEC or FINRA at adoption of or issued thereafter in connection with the pre-1992 standards for Forms S-3 and F-3 and standards approved in 1991 for Form F-10 to be valid and illustrative for purposes of interpreting the defined term “experienced issuer.” FINRA emphasizes that the proposed defined term is intended for simplification only, and incorporation of the standards into the proposed defined term would not alter the scope of public offerings subject to Rule 5110.

SIFMA does not believe that an independent financial adviser that is not engaged in the solicitation or distribution of the offering should be deemed to be “participating” in a public offering—and thereby subject to the Rule’s filing and other requirements—solely because no other FINRA member is participating in the offering. Accordingly, SIFMA suggested amending the proposed defined term

¹¹ See Securities Exchange Act Release No. 27017 (July 11, 1989), 54 FR 30013 (July 18, 1989) (File No. S7-11-88, Registration Requirements for Foreign Broker-Dealers, note 16) and Frequently Asked Questions Regarding Rule 15a-6 and Foreign Broker-Dealers, note 3, (March 21, 2013), <https://www.sec.gov/divisions/marketreg/faq-15a-6-foreign-bd.htm>.

“participate” in proposed Rule 5110(j)(16)(B) to remove the related provision. FINRA proposes to amend proposed Rule 5110(j)(16)(B) to delete “provided that another member or members is participating in the public offering.” Current Rule 5110 does not include this provision and, accordingly, deleting the language will make the approach consistent with the current Rule.

SIFMA suggested that the defined term “public offering” in proposed Rule 5110(j)(18) should expressly exclude securities offered or sold by a broker-dealer pursuant to Sections 4(a)(3) and 4(a)(4) of the Securities Act. SIFMA stated that, because these transaction types are not made pursuant to a registration statement or offering circular, they should already be excluded from the scope of the defined term and expressly referencing them in the list of excluded transaction types would be a further clarification of this result.

FINRA previously considered this issue in Response Letter No. 1. As previously explained, members have not previously filed these offerings with FINRA for review under Rule 5110 or another rule in the Rule 5100 Series and, consequently, FINRA has not been provided information regarding the operation of these offerings. The SEC recently published a concept release to solicit comment on several exemptions from registration under the Securities Act, including Sections 4(a)(3) and 4(a)(4) of the Securities Act. The SEC’s release seeks comment on possible ways to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate investor protections.¹² Based on the SEC’s work in this area, FINRA may consider future amendments to Rule 5110’s defined term “public offering” to expressly exclude securities offered or sold by a broker-dealer pursuant to Sections 4(a)(3) and 4(a)(4) of the Securities Act.

Underwriting Compensation

The Proposal would continue to provide two non-exhaustive lists of examples of payments or benefits that would be and would not be considered underwriting compensation.¹³ Although the Rule would no longer incorporate the concept of “items of value” (*i.e.*, the non-exhaustive list of payments and benefits that would be included in the underwriting compensation calculation), the proposed non-exhaustive lists are derived from the examples of payments or benefits that currently are considered and not considered items of value. The proposed examples of payments or

¹² See Securities Act Release No. 10649 (June 18, 2019), 84 FR 30460 (June 26, 2019) (Concept Release on Harmonization of Securities Offering Exemptions).

¹³ See proposed Supplementary Material .01 to Rule 5110.

benefits that would not be underwriting compensation include several new examples to provide greater clarity and to address questions raised by members.

In Partial Amendment No. 1, FINRA proposed to revise the Supplementary Material to expressly exclude non-convertible securities purchased by the participating member in a public offering at the public offering price during the review period from being deemed underwriting compensation under the Proposal. In distinguishing between non-convertible and convertible securities, FINRA noted reviewing acquisitions of convertible securities by a participating member with negotiated or preferential terms prohibited under proposed Rule 5110(g)(8) and that FINRA would consider these securities to be underwriting compensation. SIFMA stated that it understood FINRA's concern regarding securities that are acquired by participating members on preferential terms relative to other investors in a public offering, but instead suggested excluding from underwriting compensation any securities purchased during the review period by a participating member in a public offering at the public offering price and without any preferential terms not offered to others purchasing in the public offering that are not participating members.

While not dispositive, acquiring securities at the same price and on the same terms as other similarly-situated persons is generally indicative that the acquisition is not intended to provide underwriting compensation for a participating member. The Proposal includes several provisions that take into consideration whether securities were so acquired. For example, in proposed Supplementary Material .04, FINRA would take a principles-based approach to considering whether an acquisition of securities by a participating member pursuant to an issuer's directed sales program may be excluded from underwriting compensation, including considering, among other things, whether the securities were acquired on the same terms and at the same price as other similarly-situated persons participating in the directed sales program.

Accordingly, FINRA believes that it is appropriate to interpret purchases of both convertible and non-convertible securities during the review period by a participating member in a public offering at the public offering price and on the same terms as all others that are not participating members not be to underwriting compensation. SIFMA suggested introducing the concept of securities acquisitions without "preferential terms." The "preferential" concept would require a weighing and consideration of all of the various terms of a securities acquisition, which could be time consuming for members, counsel and FINRA staff and would introduce uncertainty into the evaluation. The proposed amendment would instead incorporate the concept of purchases at the same price and with the same terms to provide objectivity and clarity.¹⁴

¹⁴ Specifically, FINRA proposes to amend Supplementary Material .01(a)(7) as follows: "common or preferred stock, options, warrants, and other equity securities, including debt securities convertible to or exchangeable for equity

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In Response Letter No. 1, FINRA stated that acting as a bona fide market maker is distinguishable from acting as the underwriter in a public offering. Securities acquired by a member firm acting as a bona fide market maker would not constitute underwriting compensation under Rule 5110 because as a bona fide market maker the member is not acting as an underwriter. While noting this statement, SIFMA suggested revising proposed Supplementary Material .01(b)(21) to expressly reference “bona fide market making activity.” To provide greater clarity, FINRA proposes to amend proposed Supplementary Material .01(b)(21) to expressly reference bona fide market making.¹⁵

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FINRA believes that the foregoing responds to the material issues raised by the commenters to the rule filing. If you have any questions, please contact me at (202) 728-8013, email: Jeanette.Wingler@finra.org. The fax number of the Office of General Counsel is (202) 728-8264.

Best regards,

/s/ Jeanette Wingler

Jeanette Wingler
Associate General Counsel

securities, beneficially owned, as defined in Rule 5121 by the participating members the value of which is determined pursuant to this Rule, and acquired during the review period, as defined in this Rule, except that any such securities purchased during the review period by a participating member in a public offering at the public offering price and on the same terms as all others purchasing in the public offering that are not participating members [during the review period] shall not be deemed underwriting compensation”.

¹⁵ Specifically, the provision would be revised to state that underwriting compensation does not include “securities acquired in the secondary market by a participating member that is a broker-dealer in connection with the performance of bona fide customer facilitation activities and bona fide market making activities; provided that securities acquired from the issuer will be considered ‘underwriting compensation’ if the securities were not acquired at a fair price (taking into account, among other things customary commissions, mark-downs and other charges); and”.