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

Re: Regulatory Notice 12-27: Corporate Financing Rule: Proposed Amendments to FINRA Rule 5110 Regarding Deferred Compensation Arrangements in Public Offerings and Filing Requirements for Certain Exchange-Traded Funds

Ladies and Gentlemen:

This letter is submitted on behalf of the Federal Regulation of Securities Committee (the "Committee") of the Business Law Section (the "Section") of the American Bar Association (the "ABA") in response to the request for comments by the Financial Industry Regulatory Authority, Inc. ("FINRA") pursuant to FINRA Regulatory Notice 12-27 (the "Notice") as more fully set forth below.

This letter was prepared by members of the Subcommittee on FINRA Corporate Financing Rules of the Committee.

The comments expressed in this letter (the "Comment Letter") represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the Section.

I. Background.

FINRA Rule 5110(f)(2) sets forth certain terms and arrangements that are deemed by FINRA to be "unfair and unreasonable" when proposed in connection with a public offering of securities. In particular, FINRA Rule 5110(f)(2) imposes limitations on the ability of a FINRA member to receive so-called "tail fees" or to exercise a right of first refusal ("ROFR") when a member's engagement in respect of a proposed public offering is terminated, or the proposed public offering is otherwise not consummated. The provisions relating to tail fees and ROFRs are set forth in FINRA Rules 5110(f)(2)(D), (E), (F) and (G).

In particular, FINRA Rule 5110(f)(2)(D) prohibits:

"The payment of any compensation by an issuer to a member or person associated with a member in connection with an offering of securities that is not completed according to the terms of agreement between the issuer and underwriter, except those negotiated and paid in connection with a transaction that occurs in lieu of the proposed offering as a result of the efforts of the underwriter and related persons and provided, however, that the reimbursement of out-of-pocket accountable expenses actually incurred by the member or person associated with a member shall not be presumed to be unfair or unreasonable under normal circumstances."

FINRA Rule 5110(f)(2)(E) prohibits:

"Any "tail fee" arrangement granted to the underwriter and related persons that has a duration of more than two years from the date the member's services are terminated, in the event that the offering is not completed in accordance with the agreement between the issuer and the underwriter and the issuer subsequently consummates a similar transaction, except that a member may demonstrate on the basis of information satisfactory to FINRA that an arrangement of more than two years is not unfair or unreasonable under the circumstances."

FINRA Rule 5110(f)(2)(F) prohibits:

"Any right of first refusal provided to the underwriter or related persons to underwrite or participate in future public offerings, private placements or other financings that:

(i) has a duration of more than three years from the date of effectiveness or commencement of sales of the public offering; or

(ii) has more than one opportunity to waive or terminate the right of first refusal in consideration of any payment or fee."

And, FINRA Rule 5110(f)(2)(G) prohibits:

"Any payment or fee to waive or terminate a right of first refusal regarding future public offerings, private placements or other financings provided to the underwriter and related persons that:

(i) has a value in excess of the greater of 1% of the offering proceeds in the public offering where the right of first refusal was granted (or an amount in excess of 1% if additional compensation is available under the compensation guideline of the original offering) or 5% of the underwriting discount or commission paid in connection with the future financing (including any overallotment option that may be exercised), regardless of whether the payment or fee is negotiated at the time of or subsequent to the original public offering; or

(ii) is not paid in cash."

With respect to proposed capital raising transactions by issuers involving the distribution services of one or more FINRA members, the Notice recognizes that members often enter into engagement letters/agreements with issuers that provide the member with a ROFR in order to act in an agreed-upon capacity in a subsequent (public or private) financing transaction. In addition, the Notice recognizes that engagement letters and similar agreements often also provide for the payment by the issuer of a "tail fee" to the member in the event that a capital raising transaction is not consummated by the issuer, as contemplated by the engagement letter/agreement, but where the issuer subsequently consummates a similar transaction with a different member within a specified period of time (within two years after the termination of the first engagement).

As set forth in the Notice, FINRA's Corporate Financing Department currently interprets FINRA Rule 5110 to provide that (i) a member may not exercise a ROFR with respect to a subsequent public or private offering when a member's participation in the original (public offering) transaction is terminated on the grounds that the "payment" of a ROFR would not be permitted under FINRA Rule 5110(f)(2)(D), which rule only allows a member to receive reimbursement of its "out-of-pocket accountable expenses actually incurred" by the member if the original transaction is not completed according to the terms of agreement between the issuer and the member, and not the "payment" of any other "compensation" to the member, and (ii) a member may not receive a tail fee (termination fee) except in connection with an exchange offer or similar transaction in which substantial structuring and advisory services "beyond traditional underwriting and distribution services" have been provided.[1]

II. Proposed Amendments Relating to the Treatment of ROFRs and Tail Fees.

FINRA proposes to eliminate current FINRA Rule 5110(f)(2)(E), relating to tail fees, and to amend current FINRA Rule 5110(f)(2)(D) by providing that in addition to the receipt by a member of out-of-pocket accountable expenses actually incurred by the member, the following is also a permissible exception to the general requirement that a member not be allowed to receive any compensation in connection with a public offering of securities that is not consummated according to the terms of an engagement letter/agreement between the issuer and the underwriter:

"(ii) a termination fee or a right of first refusal, as set forth in a written agreement between the issuer and the member, provided that the agreement specifies:

[1] See also Notice to Members 97-82 of the former National Association of Securities Dealers, Inc.

a. the amount of any termination fee must be reasonable in relation to the services contemplated in the agreement and any fees arising from services provided under a right of first refusal must be customary for those type of services;

b. the issuer has a right of "termination for cause," which shall include the member's material failure to provide the services contemplated in the agreement;

c. an issuer's "termination for cause" eliminates any obligations with respect to any termination fee or right of first refusal; and

d. the termination fee requires that in order for the issuer to be responsible for paying the fee, an offering or other transaction (as set forth in the agreement) must be consummated within two years of the date the engagement is terminated by the issuer."

In this regard, the proposed amendments would no longer use the term "tail" fee, but would instead use the term "termination" fee.

We support FINRA's proposals in concept as these arrangements allow issuers and underwriters to negotiate more flexible compensation arrangements and agree with the Notice that the current interpretation by FINRA of FINRA Rule 5110(f)(2) unnecessarily interferes with the business decisions of issuers and underwriters in this regard.

The aforesaid proposed amendments to FINRA Rule 5110(f)(2) would not otherwise modify or change the two-year time limit set forth in current FINRA Rule 5110(f)(2)(E) with respect to the payment of a termination fee (formerly known as a tail fee) or the three-year time limit set forth in current FINRA Rule 5110(f)(2)(F) with respect to the exercise of a ROFR or the other requirements relating to the exercise of ROFRs, including the permitted amount of any termination or waiver fees therefor in current FINRA Rules 5110(f)(2)(F) and (G).

III. Discussion of Proposed Amendments Relating to ROFRs and Tail Fees.

As noted above, the proposed amendment to FINRA Rule 5110(f)(2)(D) would permit FINRA members to receive termination fees and ROFRs arising from public offerings of securities that are not consummated, provided that the underwriter (FINRA member) and the issuer enter into a written agreement that specifies, among other things, (i) the amount of the termination fee and that such amount be "reasonable in relation to the services contemplated in the agreement" and (ii) that fees arising from services provided under a ROFR must be "customary for those type of services."

Requiring that the amount of any termination fee be "reasonable in relation to the services contemplated in the agreement" and that any fees arising from services provided under a

ROFR must be "customary for those type of services" is a regulatory standard against which the amount of any such fees should be determined or judged. As such, we do not believe that it is necessary or appropriate to have the parties agree to such standard in the agreement, and we suggest that the proposed amendment to FINRA Rule 5110(f)(2)(D) merely require that there be a written agreement between the member and the issuer that specifies the amount of any such fees or the method for the determination/calculation of such fees, but then provide, in the rule but, again, not in the relevant agreement, that in order for such fees to be deemed to be fair and reasonable, (i) any termination fee must be reasonable in relation to the services contemplated in the agreement and (ii) any fees arising from services provided under a ROFR to the member must be customary for those type of services. If the issuer and the underwriter – the parties to the applicable agreement – agree on the amount of any such fees (or the method for calculating/determining the amount of such fees), those parties, presumably, would have determined that the fees are reasonable or customary, as the case may be, so that the inclusion of a reasonable and/or customary standard, in addition to the amount of the fees or the method for determination of such fees, would seem to be superfluous and, thus, unnecessary to be restated in the applicable agreement.

In addition, the applicable agreement between the member and the issuer must specify that the issuer has the right to terminate such agreement "for cause," which shall "include" the member's "material failure to provide the services contemplated in the agreement." We suggest that an issuer's ability to terminate the applicable agreement for cause should arise *only* where, as a result of event(s) or action(s) within the direct control of the member, there is a material failure on the part of the member to provide the services, customary for those types of services, as contemplated in the agreement within a reasonable time period, but other than as result of market, political, economic or other action(s) or event(s) that are beyond the control of the member.

We also suggest that in order to prevent an issuer from "gaming" a termination to avoid having to make a payment of a termination fee to a member, a member would be entitled to receive a termination fee specified in an appropriate agreement more than two years after the date of the termination of the agreement by the issuer (other than for cause) if the issuer enters into an agreement with another member within 1-1/2 years after the termination of the agreement with the first member and that provides for another transaction to be consummated with the second member at a date that is more than two years after the termination of the agreement with the first member.

Finally, a proposed amendment to current FINRA Rule 5110(f)(2)(F) (which provision would be redesignated as FINRA Rule 5110(f)(2)(E)) would provide that a ROFR cannot have a duration of more than three years from the commencement of sales of the public offering "or the termination date of the engagement between the issuer and underwriter." In light of proposed FINRA Rule 5110(f)(2)(D)(ii)(c), as set forth above, that would provide that an issuer's "termination for cause" would eliminate any obligations with respect to any termination fee or ROFR, we suggest that the revised/amended language in proposed paragraph (f)(2)(E)(i) add at the end of "or the termination date of the engagement between the issuer and underwriter" the following: "except with respect to a "termination for cause.""

IV. Proposed Amendment to Filing Requirements for Certain Exchange-Traded Funds.

Pursuant to the Notice, FINRA Rule 5110 would also be amended by adding a new exemption from filing under FINRA Rule 5110(b)(7)(H) in respect of "offerings of securities issued by an exchange-traded fund formed as a grantor trust or statutory trust in which the portfolio assets include commodities, currencies or other assets that are not securities."

We support such an amendment as it would provide equal treatment under FINRA Rule 5110 for (open-end) exchange-traded funds regardless of whether or not such a fund is required to be registered under the Investment Company Act of 1940 (the "1940 Act"). However, it is our view that, just as an exchange-traded fund's registration status under the 1940 Act should not lead to different results under FINRA Rule 5110, an exchange-traded fund's form of organization under state law and tax classification under the Internal Revenue Code of 1986 (the "IRC") should not lead to different results thereunder.

A statutory trust refers to an entity organized under and pursuant to the Delaware Statutory Trust Act, Chapter 38 of Title 12 of the Delaware Code, 12 Del. C. § 3801 *et seq.* A grantor trust is a form of classification that may be available to an exchange-traded fund under the IRC. However, an exchange-traded fund need not be organized as a statutory trust and need not be classified as a grantor trust. An exchange-traded fund may be organized as a Delaware statutory trust, but it may also be organized as a Maryland corporation, a Massachusetts business trust, a Delaware limited partnership, or in some other form. Moreover, an exchange-traded fund may be classified under the Internal Revenue Code as a grantor trust, but it may also be classified as a "regulated investment company" or a "partnership." Conditioning the exemption from filing under FINRA Rule 5110 on the form of organization of an exchange-traded fund or the tax classification of an exchange-traded fund would not serve any regulatory purpose, and would be as arbitrary as conditioning the exemption from filing under FINRA Rule 5110 on the registration status of the exchange-traded fund under the 1940 Act.

Also, exchange-traded funds that use futures, options on futures and other derivatives to obtain exposure to currencies and commodities (whether physical commodities such as corn, copper or gasoline or financial commodities such as interest rates and indexes) often have significant amounts of cash on their balance sheets in excess of the collateral required to establish and maintain their derivatives positions. This excess cash may be invested in Treasury bills, securities guaranteed as to principal or interest by the United States, fixed-income securities issued or guaranteed by corporations in which the United States has a direct or indirect interest, or other securities. Other exchange-traded funds that obtain exposure to currencies or commodities by holding bank deposits in foreign currencies or physical commodities (such as gold bullion) do not have any material amount of excess cash that may be invested in securities. Consequently, to condition the exemption from filing under FINRA Rule 5110 on the content of the exchange-traded fund's investment portfolio would not appear to serve any regulatory purpose. Rather, the focus for the exemption should be on the fact that the exchange-traded fund is exchange-listed and open-end.

Furthermore, the term "exchange-traded fund" is nowhere defined in FINRA Rule 5110, and could be interpreted to include any vehicle for collective investment whose shares are listed for trading on a securities exchange, including, for example, a closed-end fund. A definition of the term "exchange-traded fund" for purposes of FINRA Rule 5110 would therefore be appropriate. The key distinguishing innovation that is characteristic of all exchange-traded funds and is critical for their successful operation is the existence of a secondary market for their shares on a securities exchange, where the shares trade throughout the trading day like any other equity security at prices determined by supply and demand, coupled with daily creation and redemption of shares at net asset value per share in large aggregations by certain eligible financial institutions. This innovation tends to cause the market price per share to track the net asset value per share over time, because differences between market price and net asset value create arbitrage opportunities for investors who can exploit them by increasing or decreasing the supply of exchange-traded fund shares by creating or redeeming exchange-traded fund shares at net asset value until the market price and the net asset value per share come back into equilibrium. This affords retail investors, who obtain their exposure to exchange-traded funds in the secondary market on a securities exchange, and depend for liquidity in their exchange-traded fund holdings on the existence of a secondary market in exchange-traded fund shares on a securities exchange, a high degree of assurance that they will be able to enter and exit an investment in an exchange-traded fund at a price per share that is a close approximation of net asset value per share.

In light of the foregoing, we suggest a clarification to the proposed exemption in FINRA Rule 5110(b)(7)(H) so as to state as follows:

> "offerings of securities issued by an Exchange-Traded Fund.
>
> The Term "Exchange-Traded Fund" means any issuer of securities that is an investment company or investment trust or similar form of enterprise that does not produce goods or services and that has a class of equity securities listed for trading on a national securities exchange, provided such equity securities may be created or redeemed on any business day at their net asset value per share in large aggregations by certain eligible financial institutions that are in privity of contract with the issuer."

Once again, the Committee appreciates the opportunity to submit these comments. Members of the Committee are available to meet and discuss these matters with FINRA and its staff and to respond to any questions.

Very truly yours,

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