NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
750 First Street N.E., Suite 1140
Washington, D.C. 20002
202/737-0900
Fax: 202/783-3571
www.nasaa.org

July 14, 2017

***Submitted electronically to pubcom@finra.org***

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006

**RE: Regulatory Notice 17-14: Capital Formation and Regulatory Notice 17-15: Corporate Financing**

Dear Ms. Mitchell:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I am pleased to submit the following comments in response to Regulatory Notice 17-14: Capital Formation, in which FINRA requests comment on its rules impacting capital formation, and Regulatory Notice 17-15: Corporation Financing, in which FINRA requests comment on FINRA Rule 5110 also known as the Corporation Financing Rule – Underwriting Terms and Arrangements (collectively, the "Proposals").

NASAA has worked closely with FINRA over many years on important regulatory matters as highlighted in prior comment letters.[2] This relationship stems from the fact that NASAA members regulate FINRA-member firms and the associated persons of those firms. We look forward to continued engagement with FINRA as it reviews existing rules and proposes new ones including those in the area of corporation finance.

## 1) Regulatory Notice 17-14

As stated in Regulatory Notice 17-14, FINRA is requesting comment on the effectiveness and efficiency of its rules as part of its new initiative—FINRA360. NASAA commends FINRA for undertaking a self-evaluation of its operations and programs, and for identifying opportunities "to more effectively further its mission." We believe this effort is both reasonable and appropriate,

[1] NASAA is the association of the 67 state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA serves as a forum for these regulators to work with each other to protect investors at the grassroots level and promote fair and open capital markets.

[2] *See* Comment Letter from Mike Rothman, NASAA President and Minnesota Commissioner of Commerce, to Ms. Jennifer Piorko Mitchell, Office of the Corporate Secretary, FINRA (June 19, 2017) (in response to the Special Notice – Engagement Initiative), *available at* http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/FINRA-Comment-Letter-Special-Notice-6-19-17.pdf

especially considering capital formation needs of small and growing businesses. We urge any changes to be considered in light of FINRA's important and critical investor protection mission; capital formation rules must be balanced with providing strong investor protection. FINRA should evaluate the comments received by the firms and businesses it regulates that accounts for the needs and interests of both investors and issuers. This approach should serve to guard against regulatory capture by the very firms FINRA oversees. Below are NASAA comments regarding the FINRA Funding Portal Rules and FINRA Rule 2310.[3]

**a) Funding Portal Rules**

Title III of the Jumpstart Our Business Startups Act, or JOBS Act, enacted on April 5, 2012, and corresponding Securities and Exchange Commission ("SEC") rules established the regulatory framework for funding portals. NASAA commends FINRA for finalizing its Funding Portal Rules, which took effect on January 29, 2016,[4] and for taking swift action against one funding portal that violated several provisions of Regulation Crowdfunding and FINRA rules.[5] While funding portals may be new, startup businesses, we encourage FINRA to closely monitor the portals to ensure they are operating according to regulatory requirements. FINRA should require funding portals to conduct due diligence to determine if crowdfunding issuers are in compliance with SEC rules and remove any offerings that do not comply with such rules. In certain instances, enforcement action for practices that are not in the best interests of investors should be taken (for example, forward looking statements that project performance for which the startup issuer has no reasonable basis to provide or unsupported valuations).

NASAA also understands that some funding portals may be providing an array of other services to those companies and charging for those services. If those additional services are not necessary or provided at unreasonably high prices, FINRA should address this through rule drafting and/or enforcement. NASAA also encourages FINRA to provide greater guidance regarding the types and forms (i.e., warrants, options, etc.) of compensation a funding portal can receive from listed issuers. Finally, NASAA encourages FINRA and the SEC to work together with NASAA and its members to address potential issues that may present themselves in the registration of funding portals or other intermediaries that, depending on their registration status or business models, may be precluded from acting as an intermediary in an intrastate

[3] FINRA is also seeking comment on its Capital Acquisition Broker ("CAB") rules. On January 15, 2016, NASAA submitted a comment letter to the SEC regarding the CAB rules, and we encourage FINRA to review that comment letter for any additional changes FINRA may consider as it reevaluates these rules. *See* http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/FINRA-CAB-Comment-Letter.pdf.

[4] On November 19, 2015, NASAA submitted a comment letter to the SEC regarding proposed funding portal rules. The comment letter suggested requiring funding portals to use the Central Registration Depository to register and make ongoing disclosures, which would provide a central location for regulators to easily access information regarding funding portals. It also recommended requiring an associated person of a funding portal to obtain a license; requiring funding portal rules to more closely align with conduct rules for broker-dealers; requiring funding portals to maintain books and records; subjecting funding portals to Suspicious Activity Report filing requirements; and advocated against the ability of funding portals to place mandatory pre-dispute arbitration agreements in their customer agreements. NASAA continues to recommend these suggested changes to the extent they were not captured by the final rules. *See* http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/NASAA-Comment-SR-FINRA-2015-040.pdf.

[5] *See* FINRA, Letter of Acceptance, Waiver, and Consent, No.201605156390, UFP, LLC (2016).

crowdfunded offering.[6]

**b) FINRA Rule 2310 (Direct Participation Programs "DPPs")**

NASAA commends FINRA for continuing to review Rule 2310 for direct participation programs.[7] These are complex offerings which involve significant ongoing transactions with affiliates of the sponsoring organization (i.e., investment advisory services, property management services, property acquisition and disposition services, etc.) and include an array of fees payable to the sponsor and its affiliates.

NASAA encourages FINRA to address complex deferred compensation arrangements that have become commonplace following FINRA Regulatory Notice 15-02. NASAA questions whether front-end compensation has been meaningfully lowered in the aftermath of 15-02 in light of increased higher back-end incentive fees. FINRA should reevaluate the net investment methodology under 15-02 and consider revising 15-02 to avoid certain broker compensation being disclosed as an expense. This approach could address the current complexity of the disclosures. Currently, an investor must measure multiple share classes and any quantity discounts applicable, and understand different complex deferred compensation arrangements. Offering circulars have disclosed deferred broker-dealer compensation as "ongoing shareholder servicing" or "distribution fees." This certainly implies the item as an expense as opposed to a commission. The compensation is paid regardless of the level of services provided by the broker. The disclosure may further imply that "ongoing shareholder services" are not available if the class of shares does not provide for this compensation, such as the typical Class A share. Similarly, it is unclear whether shareholder services would be available when the compensation ends. The fee should be referred to as a deferred commission and should be fully deducted from the value attributed to the account statement.

FINRA should also continue to watch valuations closely. Valuation firms have represented all programs by a sponsor, which then are included on customer account statements. Additional due diligence of the member firm should be required before using such valuation on the customer account statements. Finally, FINRA should evaluate the advertising review. A more appropriate balance of risks and rewards may require risks on the same line as the advertising content. Condensed boilerplate footnotes are not investor oriented.

**2) <u>Regulatory Notice 17-15</u>**

FINRA is seeking comment on proposed amendments to Rule 5110, which requires FINRA members who participate in an offering in which they are providing services to the issuer to file certain information with FINRA to review and approve prior to the offering taking place. The purpose of the rule is to ensure the underwriting terms are not unfair or unreasonable. As with Regulatory Notice 17-14, NASAA commends FINRA for seeking to modernize the rule and

[6] For example, 15 U.S.C § 78c(a)(80) limits the definition of funding portals to those entities engaging in offerings pursuant to the federal interstate crowdfunding provisions, which may prevent these entities from effectively participating in intrastate crowdfunding.

[7] According to data compiled by *Direct Investments Spectrum*, non-listed REITs collectively raised $1.17 billion of investor capital in public offerings in the first quarter of this year. *See* www.dispectrum.com, May/June 2017.

simplify and clarify its provisions, but FINRA must remain mindful of the importance of balancing the dual interests of both issuers and investors.

Lock-Up Provisions

FINRA proposes to change the lock-up provisions for securities considered to be underwriting compensation to require lock-up for 180 days following the date of commencement of sales of securities (rather than from the date of effectiveness). FINRA proposes this change because the first sale may not occur until long after the date of effectiveness. NASAA supports the proposed change to FINRA Rule 5110 because it will provide increased protection for investors. However, we note that the NASAA Promotional Shares Statement of Policy[8] requires a lock-in period that is much longer than 180 days. Under the NASAA Policy, promotional shares that are not fully paid will be subject to a lock-in agreement for at least one to two years following the completion of the offering. This Policy is designed to ensure that investors and promoters assume similar risks in the offering. Accordingly, NASAA urges FINRA to consider requiring a longer lock-in period under Rule 5110 in order to more closely align the interests of the underwriters with those of the investors in the offering.

Disclosure of Underwriting Compensation

Regulation S-K requires that the fees and expenses identified by FINRA as underwriting compensation be disclosed in the prospectus. FINRA Rule 5110 requires a description of each type of underwriting compensation to be paid. However, this proposal would allow the total dollar amount of underwriting compensation to be presented as a maximum aggregate amount in the prospectus rather than itemized for each type of compensation. Any discount or commission received would still be disclosed on the cover page. NASAA supports the preservation of the existing required itemized underwriter compensation disclosure. While NASAA supports a simplified and streamlined cover of the prospectus, itemized compensation allows investors to understand how money is being disbursed to underwriters. It provides investors with a better understanding of incentives underlying an underwritten public offering, and provides investors additional liability protection for any misstatements in the disclosure.

Formula for Valuing Underwriter's Warrants

FINRA Rule 5110(e)(3) currently provides a formula for the valuation of options, warrants, and convertible securities that have an exercise or conversion price. The NASAA Underwriting Expenses Statement of Policy[9] uses the same formula for the valuation of underwriter's warrants for the purpose of calculating total underwriting expenses.

The FINRA proposal removes the formula, allowing underwriters to value options, warrants, and other convertible securities received as underwriting compensation based on a securities valuation method that is commercially available and appropriate for the type of security (e.g. Black-Scholes model for options). FINRA states that this will ensure a "commercially reasonable valuation."

---

[8] *Available at* http://www.nasaa.org/wp-content/uploads/2011/07/17-PROMOTIONAL_SHARES.pdf.
[9] *Available at* http://www.nasaa.org/wp-content/uploads/2011/07/10-UNDERWRITING_EXPENSES.pdf

NASAA believes the current valuation formula serves a useful purpose by providing an objective valuation method that provides consistency across different offerings. NASAA questions the rationale for eliminating this formula and seeks further clarification on the necessity of removing the formula. However, if FINRA does determine to eliminate the valuation formula, NASAA suggests FINRA consider reinstating the pre-2004 requirement that prohibited underwriters and related persons from receiving securities that constitute underwriting compensation in an aggregate amount greater than 10% of the number or dollar amount of the securities in the public offering. The pre-2004 rule would provide a limit on the amount of securities that may be received as underwriter's compensation. We also would suggest that FINRA consider retaining the existing formula as a continued optional method of valuation.

Exclusions from "Underwriting Compensation"

Rule 5110(d)(5) provides certain exclusions from "underwriting compensation." Pursuant to Rule 5110(d)(5)(A) and (B), certain securities obtained in prior private placements will be excluded from compensation if the conditions specified in the rule are satisfied. The FINRA proposal would revise Rule 5110(d)(5)(A) and (B) to remove the condition in Rule 5110(d)(5)(A)(ii) and (B)(iv) which makes the exclusion available only to underwriters (and their affiliates) who own less than 25% of the issuer's total equity. In its release, FINRA states that Rule 5121 addresses conflicts of interest more appropriately than the 25% provision in Rule 5110(d)(5)(A)(ii) and (B)(iv).

NASAA has concerns regarding the proposed removal of the condition that limits the availability of the above-described exclusions to underwriters who acquire less than 25% of the issuer's total equity. Without this condition, larger amounts of private placement securities may be excluded from the "underwriting compensation" subject to FINRA review. In addition, underwriters may be more likely to exceed 25% ownership in issuers than under the current rule. Accordingly, FINRA's proposed change may increase the potential for conflicts of interest to arise. While FINRA maintains that Rule 5121 can address these types of conflicts, we note that Rule 5121 requires only disclosure of conflicts of interest and that an independent underwriter prepare the registration statement with the usual standards of due diligence. NASAA questions whether these protections are adequate and whether the proposed change furthers investor protection.

Further, NASAA urges FINRA to reexamine whether it is appropriate for an issuer to grant any options or warrants to underwriters. Potential conflicts could impact the due diligence process. An underwriter may not search diligently for problems in a company if it is going to be an option holder. Also, once the firm that participated in the underwriting holds company options, it could potentially skew the recommendations that the brokerage then makes to its customers.

Miscellaneous

Finally, as part of FINRA's ongoing effort to revise its rules, NASAA asks FINRA to consider banning all sales contests and similar sales incentive non-cash compensation arrangements. Contests used to promote the sale of products create almost insurmountable conflicts of interest. A person who recommends securities based solely on such incentives is not

acting in the best interest of the customer and is acting contrary to high standards of commercial honor and just and equitable principles of trade.

NASAA welcomes an opportunity to discuss these issues further. If you have any questions about these comments, please contact NASAA's General Counsel, A. Valerie Mirko, at vm@nasaa.org or (202) 737-0900.

Sincerely,

Mike Rothman
NASAA President
Minnesota Commissioner of Commerce