Jennifer Piorko Mitchell
Office of the Secretary
FINRA
1735 K St. NW
Washington, DC 20006

Re: Regulatory Notice 17-15, Corporate Financing: Proposed Changes to FINRA Rule 5110

To the FINRA Leadership Team:

I have been a securities lawyer representing broker-dealers and others in the financial services markets for 30 years. I am a former Assistant General Counsel at the SEC, a former General Counsel at a large national broker-dealer, and a former Chair of the ABA Business Law Section Subcommittee on Trading and Markets and of the SEC Historical Society. I write this letter solely on my own behalf, and not on behalf of my law firm or any clients.

I write this letter to encourage FINRA to think more broadly about the reform of FINRA Rule 5110. In my view, FINRA Rule 5110 should be converted into a disclosure-only rule, requiring full disclosure of the financial relationships between a broker-dealer and its client in any securities underwriting, but not imposing substantive restrictions on the compensation received in those relationships.

I accept that Rule 5110 was created with the best of intentions – to prevent underwriters from imposing unconscionable pricing terms on potentially vulnerable corporate clients. However, I believe the rule as currently written has done more harm than good, and would continue to do so under the amendments proposed (again, I stipulate that these amendments were proposed with good intentions) by FINRA.

FINRA Rule 5110 is a price-fixing rule, which sets the maximum compensation a broker-dealer may earn in an underwriting. Absent the approval of the SEC, the price-fixing components of Rule 5110 would be a per se violation of the federal antitrust laws (SEC approval of course creates antitrust immunity for FINRA). More than 50 years of antitrust scholarship demonstrates conclusively that fixed prices – even fixed maximum prices – almost invariably harm consumer welfare. I urge FINRA to direct its Office of the Chief Economist to perform a full analysis of the price-fixing elements of Rule 5110 and consider the alternative of a disclosure-only rule. There is only one possible conclusion such an analysis could reach.

In practice, FINRA Rule 5110 is a textbook example of why even maximum price-fixing regulations, in the end, do not benefit the public. FINRA Rule 5110 has become increasingly more complex and hard to apply, as public companies and underwriters find new ways to reach economically efficient arrangements despite the existence of the rule. As a result, FINRA must continually amend the rule to forbid new and creative means of compensation. Over time, the rule has become ever more complex, expensive and difficult to apply. This set of proposed amendments recognizes that the Rule has by now become fully Byzantine in its complexity – but in my view incremental simplification (as proposed here) is not the answer.

The underlying issue is that there will always be small, troubled public companies which have a desperate need for financing, and are willing to pay substantial compensation to obtain that financing. These troubled public companies present the highest liability risk for underwriters, and underwriters are unwilling to assist them unless they are adequately compensated for that risk.[1] And that is exactly what has happened – underwriters will not touch small, troubled public companies. But limiting the compensation that broker-dealers can receive does not remove the problems that these small, troubled public companies face. Rather, because of FINRA Rule 5110, those companies end up being shut out entirely from assistance from broker-dealers. There are a variety of funding providers (many of them hedge funds), some of which are much more unscrupulous than others, which are willing to finance these companies. Some of these providers offer financing vehicles, such as "death spiral" or "toxic" debt or preferred stock offerings, which can have very serious negative consequences for the companies and their investors. In the absence of a broker-dealer to help companies navigate this complex and non-transparent landscape of potential financers, many companies end up choosing financing options that are highly sub-optimal. As a result, many of these companies end up with financing options much worse than they could have obtained with the assistance of a sophisticated broker-dealer experienced in this market. FINRA Rule 5110 does not solve the problem of small troubled companies in need of financing – it simply moves that problem to a largely non-transparent and unregulated environment, to the significant detriment of the companies and their investors.

Moreover, the complexity of FINRA Rule 5110 imposes substantial costs on all underwritings, not just those for the small, troubled companies the rule was designed to protect. The complexity of Rule 5110 has resulted in the development of a small bar of law firm outside counsel who can follow the complexities of the rule – many of these complexities not contained in the rule itself, but in interpretive letters or only learned through the processing of individual applications. The ABA Business Law Section has a subcommittee devoted exclusively to this topic (itself a sign that the rule has metastasized well beyond its original intent). The need to consult this small and highly-compensated coterie of experts on every transaction, just to fill out FINRA's forms correctly and obtain prompt approval of the transaction, creates expense and delay for every transaction, even for those for which there is no substantive concern about the compensation at issue. This approval process is in effect a tax on every underwritten transaction – and serves as a substantial incentive instead to conduct private placements or other transactions without an underwriter directly with a hedge fund that are outside of the scope of the rule.

Twenty years ago the NASD abandoned its excess spread rule for market-makers – also a rule originally created with good intentions but which in practice proved to have an adverse impact on the markets. FINRA Rule 5110 is this generation's excess spread rule – a rule adopted with good intentions but that has outlived whatever use it may have once have had. FINRA has every reason to require full disclosure of the economic relationships between underwriters and public companies, and I support full disclosure of those relationships. But it has proven counter-productive for FINRA to try to regulate the substantive levels of compensation in transactions

[1] The executive management of small public companies is less in need of substantive protections than, for example, the primarily retail investors protected by the mark-up/mark-down limits in FINRA Rule 2121.

between underwriters and their corporate clients. I urge FINRA to rethink Rule 5110 from the ground up, and consider whether a disclosure-only version of the rule would better support capital formation without any unnecessary harm to customer protection. In particular, I believe a full analysis by the Office of the Chief Economist would confirm that the substantive price-fixing in Rule 5110 harms overall public welfare. The SEC in the new administration is attempting to encourage small business capital formation, to make it easier for small companies to go public, and to make it simpler for those small companies to raise capital after they have become public. A disclosure-only version of FINRA Rule 5110 would make it quicker, cheaper and easier for small public companies to raise capital, and in the end this result not only would help broker-dealers, but also would benefit public companies and their investors.

Sincerely,

W. Hardy Callcott