PUBLIC INVESTORS ADVOCATE BAR ASSOCIATION
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August 8, 2023

Via Electronic Mail
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506
PubCom@finra.org

Re: FINRA Regulatory Notice FINRA 23-09; Additional changes to Rules, Operations or Administrative procedures to further promote Capital Formation.

Dear Ms. Piorko:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") relating to both investor protection and disclosure. As such, PIABA frequently comments upon proposed rule changes and retrospective rule reviews in order to protect the rights and fair treatment of the investing public.

FINRA has requested, via Regulatory Notice 23-09, comment on whether additional changes should be made to existing FINRA rules, operations or administrative procedures to further promote capital formation by member firms. It should be noted PIABA previously commented on SR-FINRA-2020-38 which proposed a rule change to Amend FINRA Rules 5122 (Private Placements of Securities Issued by Members) and 5123 (Private Placement of Securities). The concerns raised in that prior comment letter remain and underpin our concerns with this current undertaking.

Background

FINRA's stated belief that a vital component of economic growth is the ability of businesses of all sizes to efficiently raise capital requires periodic changes to existing rules to allow businesses to "launch, expand, modernize, innovate and create jobs. In turn, well-functioning securities markets that promote issuer and investor confidence are essential to the capital-formation process."[1] The SRO further states "throughout the lifecycle of this process, FINRA members are central to both public and private markets—underwriting public offerings, advising companies on capital raising and corporate restructuring, acting as placement agents for some sales of unregistered securities, operating funding portals, and publishing research reports to educate and inform investors."[2]

This backdrop sets the stage for contemplating additional revisions to a variety of FINRA rules, many of which were already revised as recently as 2019. Those rules include: Regulating member firm capital formation, including Rules 2210 (Communications with the Public), Rule 2241 (Research Reports), Rule 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements) and FINRA's Offering System, as well as Rules 5122 and 5123 (Private Placements – the subject of our last comment letter on this subject), Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) and Rule 5131(New Issue Allocations and Distributions). Finally, FINRA Rule 11880 (Settlement of Syndicate Accounts) might warrant review.

Comment

As is the case with many such amendment proposals, PIABA strongly believes FINRA must balance the goal of promoting membership objectives while keeping a keen eye on preventing abuse. As history has clearly shown, capital formation is a fertile area for potential exploitation. For example, and by FINRA's own acknowledgement:

> In recent years, the private placement market outpaced the public market. From 2009 to 2019, the amount of capital raised in Regulation D offerings more than doubled…member involvement in private placements has kept pace with the growth of the Regulation D market in general. For instance, the number of Regulation D filings submitted by members pursuant to FINRA Rules 5122 and 5123 has increased to over 3,800 unique filings in 2021 in comparison to roughly 2,000 submissions in 2013.[3]

The number of persons who can invest in private placements had increased substantially over the last several decades as well. In a December 2019 statement, SEC Commissioner Allison Herren Lee estimated that this accredited investor pool will grow to 22.7% of American households in the next decade.[4] PIABA members' experience demonstrates, conclusively, that there is not a connection between an investors' net worth or income and their investment acumen. The increasing pool of "accredited" investors means that more investors lacking the sophistication or financial wherewithal to adequately ascertain the risks of these investments will nonetheless be pitched to invest in them. We find this trend concerning.

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[1] Regulatory Notice 23-09, page 2.
[2] Id.
[3] Regulatory Notice 23-09, page 6.
[4] https://www.sec.gov/news/public-statement/statement-lee-2019-12-18-accredited-investor#_ftnref6

The financial motivation to sell these products over registered investment options is obvious. These products typically offer the sellers commissions between 5% and 8%. Those commissions are far higher than what brokers would make selling more typical investments, including mutual funds, stocks, or bonds. Take, for example, registered Broker-Dealer Crown Capital. According to its own financial reports with the SEC, in 2020 it generated more in commissions selling partnerships than it did selling traditional equities.[5] And Crown Capital didn't handle the commissions well; the firm entered into an AWC in 2022 regarding having paid $19.3 million in commissions to unregistered corporate entities. The financial incentive to push unregistered securities is strong: PIABA members see brokers who generate huge proportions of their income selling unregistered securities to retail customers, comprising as much as 90% of their total revenue.

Broadly pushing unregistered securities is problematic; FINRA itself has previously warned about some of the problems with private placements, such as non-traded real estate investment trusts.[6] These cautions have included warnings about the extremely limited liquidity, and very high fees associated with non-traded REITs. Moreover, due, in part, to the huge up-front costs, these products historically underperform their publicly traded counterparts. So, investors take far higher risks for far lower rewards. Despite this, brokers commonly tout the "stability" of these products relative to the stock market. The premise is known as the "stable investment" myth. The theory is because one cannot see the daily fluctuations, like in the stock market, that the investments' intrinsic value does not fluctuate. Privately traded investments, or private companies in general, obviously have rising and falling values based on a host of factors. The fact that the investor does not see the fluctuations, as they are not public, does not mean the investment in question is not losing its value rapidly. The illiquid nature of the securities further depresses the valuations.

The reality is that these types of products are almost invariably start-up businesses. They have no track record, and they have no assets. At best, they have a business idea and plan. As a result, the investors are bearing the massive start-up costs that these businesses entail. Many of these investments carry up-front costs over 10% thanks to underwriting costs, and charges paid to sponsors and selling brokers. That means that day 1, the "non-volatile" investment is already down 10%, even though the monthly brokerage statement likely will not reveal the drop. While investors are pitched the idea of meaningful distributions from the securities, those distributions are not guaranteed, and are often funded with money raised from newer investors.

The Reg. D filing acceleration is indicative of the challenges faced by regulators in an ever-expanding marketplace. Any proposals that encourage capital formation, by way of weakening existing protections within the corresponding FINRA rules, is perilous to consumers and vehemently opposed by PIABA membership.

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[5] See Crown Capital, X-17A-5 (Dated March 2, 2021) at 8, available at https://www.sec.gov/Archives/edgar/vprr/2100/21002101.pdf.

[6] *See* FINRA, *Public Non-Traded REITs- perform a Careful Review Before Investing* (October 4, 2011).

In summary, PIABA is opposed to any substantive additional rule changes without a thorough vetting of the proposals combined with the inclusion of additional investor protection guardrails.

Very Truly Yours,

Hugh Berkson
President, Public Investors Advocate Bar Association