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Invested in America

August 7, 2023

Submitted via email to: PubCom@finra.org
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 23-09
FINRA Requests Comment on FINRA Rules Impacting Capital Formation

Dear Ms. Mitchell:

The Securities Industry and Financial Markets Association ("SIFMA" or "we")[1] appreciates the opportunity to respond to the request for comment by the Financial Industry Regulatory Authority, Inc. ("FINRA"), set forth in Regulatory Notice 23-09, issued May 9, 2023 ("Regulatory Notice 23-09"),[2] which addresses certain rules, operations and administrative processes impacting capital formation in the securities markets and questions how such rules could change to further enhance the capital raising process without compromising protections for investors and issuers.

I. Introduction

SIFMA supports FINRA's efforts to review and consider changing its rules, operations and administrative processes as they relate to the capital markets to increase efficiency and reduce unnecessary burdens on the capital raising process without compromising protections for investors and issuers. We acknowledge and appreciate the extensive effort FINRA has made over the years to meet with and hear from interested parties, including many of our members. Regulatory Notice 23-09 represents an important opportunity to provide feedback on areas of regulation that are impeding the capital formation process without the corresponding benefit of meaningful investor protection.

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[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] *See* FINRA Regulatory Notice 23-09 (May 9, 2023), *available at* https://www.finra.org/rules-guidance/notices/23-09.

In this regard, SIFMA believes the modifications and clarifications of the rules detailed below are of significant importance to increasing the efficiency and effectiveness of FINRA's regulation of capital formation, while continuing to promote transparency and establish important standards of conduct for its members and maintaining appropriate protections for investors and issuers.

II. FINRA Rule 5123: Amendment to FINRA Rule 5123(b)(1)(J)

According to Regulatory Notice 23-09, the requirement for member firms to file information on the private placements they sell under Rule 5123, Private Placements of Securities, helps FINRA assess the risks associated with those offerings and identify those that are potentially problematic. There are several exemptions from the FINRA Rule 5123 filing requirement for offerings sold to certain investors that satisfy specified criteria that demonstrate a "sufficiently high level of sophistication to justify exemption from Rule 5123."[3] Among those offerings that are exempt from the filing requirements are those that are sold to institutional accredited investors as defined under Rule 501(a)(1), (2), (3), or (7) of Regulation D.

In 2020, the U.S. Securities and Exchange Commission ("SEC") amended the definition of "accredited investor" under Rule 501(a) to include under a new subsection (a)(9) any entity of a type not listed in (a)(1), (2), (3), (7), or (8) not formed for the specific purpose of acquiring the securities offered, owning investments in excess of $5,000,000. The amendments also included a new subsection (a)(12) for any "family office" [4] not formed for the specific purpose of acquiring the securities offered, owning investments in excess of $5,000,000 and whose prospective investment is directed by a person who has sufficient knowledge and experience to evaluate the merits and risks of the prospective investment.[5]

FINRA Rule 5123 was adopted in 2012 and, therefore, its current exemptions became effective before the 2020 amendments to Rule 501 were adopted.[6] As described in greater detail below, subsections (a)(9) and (12) demonstrate a "sufficiently high level of sophistication to justify exemption from Rule 5123".[7] SIFMA urges FINRA to include these institutional investors within the enumerated exemptions under FINRA Rule 5123(b)(1)(J).

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[3] *Id*.

[4] Family office is defined to mean "a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) that: (1) Has no clients other than family clients; provided that if a person that is not a family client becomes a client of the family office as a result of the death of a family member or key employee or other involuntary transfer from a family member or key employee, that person shall be deemed to be a family client for purposes of this section for one year following the completion of the transfer of legal title to the assets resulting from the involuntary event; (2) Is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and (3) Does not hold itself out to the public as an investment adviser. (*See* Investment Advisers Act of 1940 (17 C.F.R. §275.202(a)(11)(G)–1).

[5] *See* 17 C.F.R. § 230.501.

[6] *See* Amending the "Accredited Investor" Definition, SEC Release Nos. 33-10824; 34-89669 (August 26, 2020).

[7] *See* Notice of Filing of Amendments No. 2 and No. 3 and Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendments No. 1, No. 2, and No. 3 to Adopt FINRA Rule 5123 (Private Placements of Securities) in the Consolidated FINRA Rulebook, SEC Release No. 34-67157 at 12 (June 7, 2012).

Rule 501(a)(9) serves as a catch-all for entities that are not already enumerated in Rule 501(a)(1), (2), (3), (7), or (8). Rule 501(a)(9) also establishes additional criteria that the entities are not formed for the specific purpose of acquiring the securities offered, and own investments in excess of $5,000,000, which helps ensure that such entities are not formed with the purpose of evading the protections of the federal securities laws as they relate to accredited investors, and have a certain level of sophistication. Moreover, as a practical matter, the SEC has concluded that there is no difference in the level of sophistication between the entities listed in Rule 501(a)(1), (2), (3), (7), or (8) and those in 501(a)(9); and, therefore, the entities covered by Rule 501(a)(9) should be included in the exemptions from the Rule 5123 requirements.

In 2020, when amending Rule 501 of Regulation D to include in the definition of "accredited investor" certain family offices in Rule 501(a)(12), the SEC noted in the Adopting Release that it believed that family offices can sustain the risk of loss of investment, and that protections otherwise afforded to less financially sophisticated investors by federal securities laws are not necessary to protect family offices or their clients.[8]

In the Rule 5123 Adopting Release,[9] FINRA expressly declined to apply the exemption to all accredited investors, noting "that the criteria used to measure whether a person meets the accredited investor standard do not necessary reflect a sufficiently high level of sophistication to justify exemption."[10] We agree with FINRA that not every accredited investor meets the criteria for inclusion within the exemptions of Rule 5123(b). However, the SEC's objective when amending Rule 501 was to exclude or facilitate investments for investors who satisfy certain characteristics. As noted above, such amendments were proposed and adopted after FINRA Rule 5123 was adopted in 2012 and its current exemptions became effective. In this regard, consistent with SEC policy, family offices are not the type of investors that need additional protections that the disclosure and filing requirements and additional oversight FINRA provides under FINRA Rule 5123. Moreover, the $5,000,000 minimum threshold set forth in Rule 501(a)(9) and (a)(12) makes these exemptions comparable to the exemptions set forth in Rule 501(a)(2), (3), and (7), which FINRA already exempts from the requirements under Rule 5123.

III. FINRA Rule 5110: Valuation of non-convertible preferred securities

Rule 5110 regulates the terms and conditions of the participation of FINRA member broker-dealers in public offerings. The Rule prohibits underwriting arrangements in connection with those offerings if the underwriting terms and conditions are deemed under the Rule to be "unfair" or "unreasonable."

Under FINRA Rule 5110(g)(1), a participating member, which is defined to include any FINRA member that is participating in a public offering, any affiliate or associated person of the member,

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[8] *See* SEC Release Nos. 33-10824; 34-89669 at 60 (August 26, 2020) (reasoning that the policy rationale for adopting the family office rule supports the inclusion of family officers in the definition of accredited investor).

[9] *See* SEC Release No. 34-67157 (June 7, 2012).

[10] *See id.* at 12 (declining to expand the scope of exemptions as requested by various comment letters).

and any immediate family under Rule 5110 (collectively, "Participating Member")[11] is prohibited from receiving any underwriting compensation for which a value cannot be determined.[12] In this regard, FINRA has deemed non-convertible preferred securities to be among those that cannot be valued and are, therefore, per se unreasonable compensation to be received by a Participating Member during the review period[13] of a public offering of securities. As a consequence, when an affiliate of a Participating Member, as part of its business strategy, acquires non-convertible preferred securities of a company at a time which falls within the review period of a subsequent public offering by that company, such Participating Member would automatically be disqualified from participating in that offering unless it divests itself of the non-convertible preferred securities.

SIFMA believes that these securities can be properly valued by nationally recognized accounting firms because they are regulated at the federal and state levels and subject to auditing standards set forth by the Public Company Accounting Oversight Board ("PCAOB"), and approved by the SEC. Current PCAOB standards for auditing the fair value of financial instruments require assessing, among other things, (i) the reliability of third-party pricing information; (ii) whether fair values are based on quoted prices in active markets for identical financial instruments; and (iii) metrics for determining what makes a transaction comparable.[14] Moreover, the valuation of these securities could be provided by the accounting firm as part of the Participating Member's audited financial statements.[15]

For these reasons, SIFMA encourages FINRA to consider accepting the valuation of non-convertible preferred securities prepared by a PCAOB-certified accounting firm to allow Participating Members to receive such securities and to avoid the consequence of excluding FINRA members from participation in a public offering if they or their affiliates acquired such securities during the review period or forcing them to sell such securities under duress.

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[11] *See* FINRA Rule 5110(j)(15).

[12] In the Adopting Release (as Rule 270 of the NASD Conduct Rules), it was stated that this prohibition is meant to "address novel forms of compensation by establishing the general requirement that all items of value deemed to be underwriting compensation must have a determinable value at the time of the offering in order for [the relevant regulatory authorities] to calculate the aggregate underwriting compensation in connection with an offering." *See* SEC Release No. 34-30587 (April 15, 1992).

[13] The definition of "review period" includes the 180-day period preceding the required filing date through the 60-day period following the effective date of the offering. *See* FINRA Rule 5110(j)(20).

[14] *See* AS 2501: Auditing Accounting Estimates, Including Fair Value Measurements, PCAOB, *available at* https://pcaobus.org/oversight/standards/auditing-standards/details/AS2501.

[15] FINRA has accepted the use of widely accepted accounting principles in other areas of its rulemaking. For example, FINRA Rule 4140 permits FINRA to call for an audit of its members made by "an independent public accountant" or "standards prescribed by the AICPA." *See* FINRA Rule 4140(a).

IV. FINRA Rule 5110: Amendment to Supplementary Material .01(b)(14)

Supplementary Material .01(b)(14) provides that securities acquired as a result of a conversion of securities that were originally acquired prior to the review period are not underwriting compensation and, therefore, not subject to the lock-up requirements under the rule.[16]

SIFMA requests that FINRA amend Supplementary Material .01(b)(14) to include securities acquired by a Participating Member as the result of a conversion *or exchange* when the right to an exchange is part of the terms of the securities initially purchased. It follows that if a Participating Member were to receive securities of the issuer as part of any exchange, such securities would not be subject to the lock-up restriction under the rule.

As a general matter, an investor, including a Participating Member, should be entitled to receive the same exchange rights of the terms of the security at the time of purchase and the time such rights are triggered; any other result would put into question the valuation of the underlying security, while adding nothing to the integrity of the offering process or the protection of investors or issuers.

SIFMA believes it would deter capital formation if the original terms of the securities are not granted at the time they vested. When rights are established outside of the review period, they should continue to remain effective and enforceable during the review period. Moreover, such amendment would be consistent with the reasonable expectations of Participating Members and, accordingly, would be more equitable without affecting the integrity of the offering process or the protections intended to be provided in the interests of investors and issuers.

V. FINRA Rule 5110: Amendment to Supplementary Material .01(b)(16)

Similarly, Supplementary Material .01(b)(16) provides that securities acquired as the result of a stock-split where the securities *upon which the acquisition is based were acquired prior to the review period are not underwriting compensation*.[17] However, as the rule is currently drafted, securities received in a stock-split during the review period would be deemed to be underwriting compensation if the securities on which the stock-split was based were acquired during the review period, even if such securities were themselves not deemed to be underwriting compensation under FINRA Rule 5110.

SIFMA urges FINRA to broaden this exclusion from underwriting compensation to include securities acquired as the result of a stock-split where the securities upon which the acquisition is based were not otherwise underwriting compensation under the rule, including FINRA Rule 5110(d) or Supplementary Material .01(b). For example, if securities acquired are deemed not to be underwriting compensation because they meet an exemption in Rule 5110(d), such as the exemption for securities acquired in co-investments with certain regulated entities, then any

[16] FINRA Rule 5110 Supplementary Material .01(b)(14).

[17] FINRA Rule 5110 Supplementary Material .01(b)(16).

securities received pursuant to a stock-split of those securities should not be deemed underwriting compensation.

We believe that an amendment specifying that a later stock-split of securities that are excluded from the definition of underwriting compensation at initial purchase is consistent with the intended scope of Supplementary Material .01(b)(16). Moreover, as noted with respect to our comment in Section IV of this letter, such an amendment would be consistent with the reasonable expectations of Participating Members and, accordingly, would be more equitable without affecting the integrity of the offering process or the protections intended to be provided in the interests of investors and issuers.

VI. FINRA Rule 5110: Securities Acquired by Associated Person

As set forth in SIFMA's letter dated June 1, 2017,[18] we continue to believe that Supplementary Material .01(b) should include an exception for any cash compensation, securities or other benefit received by a person that was not, at the time of acquisition, an associated person, immediate family member or affiliate of a Participating Member. This clarification would promote investments in securities by an associated person or one of its family members, without the concern that a change in member firm's status would impose unpredictable regulatory risks on such purchase in the event such member firm in the future participates in a public offering subject to Rule 5110.

VII. FINRA Public Offering System

Pursuant to Regulatory Notice 23-09, FINRA has enhanced its Public Offering System through advanced technologies that enable it to extract information from SEC and FINRA databases that lessen reliance on outside counsel to supply publicly available information regarding the issuer and the underwriting terms and arrangements.

SIFMA welcomes FINRA's enhancements to the functionality of the Public Offering System, including its ability to access the registration statement in the SEC's Electronic Data Gathering, Analysis, and Retrieval system and populate the FINRA filing with the information necessary to conduct a review.[19] As part of this functionality, SIFMA encourages FINRA to incorporate a feature that will enable it to populate the name of the issuer and the Participating Members from the prospectus into the FINRA filing, and to notify the outside counsel listed in the FINRA filing via email each time FINRA issues a comment on the Public Offering System.

We believe these changes will streamline the FINRA filing process, facilitate the comment and review process that will ultimately lead to the Participating Members' receipt of the No Objections letter in a more timely manner and reduce the burden on FINRA Staff and systems.

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[18] *Available at* https://www.finra.org/sites/default/files/notice_comment_file_ref/17-15_sifma_comment.pdf.

[19] *See* FINRA Regulatory Notice 20-10 (March 20, 2020), *available at* https://www.finra.org/rules-guidance/notices/20-10.

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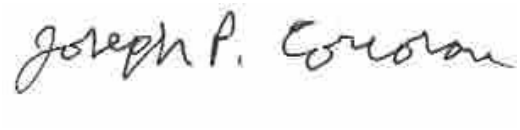
SIFMA appreciates this opportunity to comment on Regulatory Notice 23-09 and thanks FINRA in advance for its consideration of this submission. SIFMA would be pleased to discuss any of these points further and provide additional information that would be helpful. Please do not hesitate to contact the undersigned or SIFMA's outside counsel, Jennifer Morton of Shearman & Sterling LLP, at (212) 848-5187.

Sincerely,



Joseph Corcoran
Managing Director and Associate General Counsel
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cc: Robert W. Cook, President and Chief Executive Officer, FINRA
Robert L.D. Colby, Chief Legal Officer, FINRA
Joseph Price, Senior Vice President, Corporate Finance and Advertising Regulation, FINRA