July 7, 2025

Submitted via email to: pubcom@finra.org

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
Financial Industry Regulatory Authority, Inc.
1700 K Street, N.W.
Washington, D.C. 20006

Re: <u>Regulatory Notice 25-06: Request for Comment on Modernizing FINRA Rules, Guidance and Processes to Facilitate Capital Formation</u>

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 25-06 (the "Notice"), as more fully set forth below.

This letter was prepared by members of the Committee's Subcommittee on FINRA Corporate Financing Rules. The views expressed in this letter represent the views of the Committee only and have not been reviewed or approved by the House of Delegates or Board of Governors of the ABA and should not be construed as representing the position of the ABA. In addition, this letter does not necessarily reflect the views of all members of the Section, the Committee, the drafting committee or their respective firms or clients.

I. Description of the Notice

The Committee applauds FINRA's ongoing commitment to supporting the capital-raising process and appreciates the major advances already made in reducing unnecessary costs and burdens on capital formation. The Notice requests comment on whether additional changes to

FINRA rules, guidance, operations or administrative processes would further facilitate capital formation and reduce costs and burdens on capital formation. The Committee supports FINRA's continued efforts to increase efficiency and modernize its rules and welcomes the opportunity to suggest further improvements, as discussed below.

II. Comments

A. <u>Rule 5110</u>

1. Rule 5110(j)(10), Rule 5110(d)(2) and (3) and Rule 5110 Supplementary Material .07 – Application of Institutional Investor Definition in Venture Capital Exceptions

Securities acquired in transactions that meet one of the venture capital exceptions in Rule 5110(d) are excluded from underwriting compensation and not subject to the lock-up requirements of Rule 5110(e)(1). Under Rule 5110 supplementary material .07, the determination of whether a securities acquisition meets the conditions of a venture capital exception must be made at the time of the securities acquisition. As described below, there is uncertainty as to how to apply the "institutional investor" definition in Rule 5110(j)(10) with respect to the applicable venture capital exception conditions at the time of a securities acquisition.

The venture capital exceptions set forth in Rule 5110(d)(2) and (d)(3) contain conditions that incorporate the term "institutional investor," as defined in Rule 5110(j)(10). Rule 5110(d)(2)(B) and (C) require that:

- institutional investors beneficially own at least 33% of the issuer's total equity securities, calculated immediately prior to the transaction; and
- the transaction was approved by a majority of the issuer's board of directors (if the issuer has a board of directors) and a majority of any institutional investors, or the designees of institutional investors, that are board members.

Rule 5110(d)(3)(A) and (B) require that:

- institutional investors, none of whom is an affiliate of a member participating in the offering purchase at least 51% of the total number of securities sold in the private placement at the same time and on the same terms; and
- an institutional investor was the lead negotiator or, if the terms were not negotiated, was the lead investor with the issuer to establish or approve the terms of the private placement.

Under Rule 5110(j)(10), and for purposes of the foregoing venture capital exception conditions, the term "institutional investor" is defined as:

> any person that has an aggregate of at least $50 million invested in securities in its portfolio or under management, including investments held by its wholly owned subsidiaries; *provided that no participating members manage the institutional investor's investments or have an equity interest in the institutional investor, either individually or in the aggregate, that exceeds 5% for a publicly owned entity or 1% for a nonpublic entity*. (emphasis added)

To be an institutional investor under the foregoing definition, no FINRA members participating in the relevant public offering can manage such investor's investments or have an equity interest in the investor, either individually or in the aggregate, exceeding the noted thresholds. However, the full underwriting syndicate for a public offering is rarely known or knowable at the time of a venture capital securities acquisition, given such acquisition must occur before the first confidential submission of the registration statement for the offering. Therefore, if the reference to participating members in this definition is interpreted broadly to be forward-looking and include FINRA members that become participating members after the venture capital investment, a venture capital investor cannot determine compliance with the applicable venture capital exception at the time of its securities acquisition. This is incompatible with Rule 5110 supplementary material .07, which requires a determination as to whether a securities acquisition meets the requirements of a venture capital exceptions at the time of the acquisition. In addition, it is very difficult if not impossible for a venture capital investor attempting to rely on one of these exceptions to obtain the necessary diligence information as to whether other unaffiliated third-party investors meet the definition of institutional investor for purposes of the relevant exception conditions.

Due to the uncertainty in this area, investors often cannot reliably determine the applicability of the venture capital exceptions in Rule 5110(d)(2) and (3) at the time of an investment. This has resulted in some investors avoiding an investment altogether, which hinders capital raising by issuers. Also, an investor that nevertheless proceeds with the investment must take the risk that the securities acquisition may not qualify for a venture capital exception, depending on future participating members, which could result in the severe consequence of the investor or its affiliated broker-dealer not being able to participate in the public offering. Accordingly, we request that the proviso in the definition of institutional investor in italics above be eliminated entirely.

Alternatively, if FINRA does not agree with the approach above, we request guidance or an amendment to Rule 5110(j)(10) clarifying that "participating members" under the definition of “institutional investor” for purposes of the venture capital exceptions means only those FINRA members actually mandated by the issuer to participate in the relevant public offering as of the time of the venture capital securities acquisition. Such guidance would be consistent with the timing of the determination requirement under supplementary material .07 and would make the exemptions operable.

2. Guidance Regarding Treatment of Sales of Securities Prior to Offering Commencement

In the event that a securities acquisition fails to meet a venture capital exception because of the issues described above or otherwise fails to meet an exception to underwriting compensation, we would appreciate guidance as to whether such securities would still be counted as underwriting compensation if sold to an unaffiliated third party prior to the commencement of the public offering in which the member is participating. If so, how would compensation be calculated and what factors would FINRA consider important for this analysis?

3. De Minimis Exception for Disclosure Regarding Underwriting Compensation

We respectfully request that you consider including a de minimis exception in the provision relating to disclosure of underwriting compensation (new section .06 of the Supplementary Material to Proposed Revised Rule 5110 set forth in Attachment A to FINRA Regulatory Notice 24-17). For example, if the value of securities acquired by an underwriter, its affiliates and/or associated persons during the review period is extremely small, we don’t believe it will be relevant to an investor. In addition, collecting the information to value a very small interest can be extremely time consuming. For example, determining the value of a very small limited partnership interest held by an associated person of an underwriter in a limited partnership that acquired securities of the issuer during the review period can be very time consuming. Similarly, if the amount of expenses to be paid to underwriters’ counsel for the FINRA qualification of the offering is a minute percentage of gross offering proceeds, that amount is unlikely to cause investors to question underwriting compensation. With regard to the size of the de minimis exception, we would suggest that it be a very small percentage of the amount of gross offering proceeds disclosed in the final prospectus but are not suggesting a specific amount.

4. Simplification of the Procedure for Filing S-1 Resale Shelves

FINRA’s current two-step procedure for the review of offerings off of a Rule 415 “resale” shelf on Form S-1or F-1 is unnecessarily cumbersome and can cause delays in such offerings. We would be very grateful if FINRA would streamline the filing process by eliminating the requirement that the shelf and the draft prospectus supplement be filed separately (i.e., as separate offerings). Because it can take days for a draft prospectus supplement to be separately cleared in these transactions, the timing of a proposed takedown can be very difficult for selling stockholders expecting to be able to sell off of an S-1 or F-1 shelf registration statement.

Finally, we believe that it would be extremely helpful if FINRA were to publish FAQ or other guidance describing the required filing procedure, including, but not limited to whether each prospectus supplement issued off of an S-1 resale shelf is required to be filed and approved prior to the subject offering and a discussion of FINRA's concerns regarding these filings.

5. Former Associated Persons of a Participating Member

We respectfully request that once an issuer's executive officers or directors are no longer associated persons of participating members as of the required filing date, FINRA conclude definitively that any customary compensation paid by the issuer to such persons is not underwriting compensation. The determination of what is customary, in the case of a director, would be made by reviewing compensation paid to the issuer's other directors or, in the case of an executive officer, such determination could be made by reviewing the compensation of the executive officer's predecessor or other executive officers of the issuer. Merely because an executive officer or director was formerly associated with a participating member, his or her compensation from the issuer should not be viewed as underwriting compensation to the member with whom such person was associated.

B. Rule 2310

Rule 2310 regulates underwriting compensation and offering expenses of direct participation programs ("DPPs"). In particular, the organization and offering expenses ("O&O Expenses") are limited to 15% of the gross proceeds of the offering where issuer and dealer manager are affiliates. We ask for guidance on how to calculate 15% of the gross proceeds for a perpetual-life REIT or BDC subject to Rule 2310. A registration statement on Form S-11 used to register securities offerings by REITs and registration statement on Form N-2 used to register securities offerings by BDCs are effective for 3 years. For perpetual-life vehicles a new registration statement is filed every 3 years. It is our understanding that FINRA treats each new registration statement as a new offering and measures underwriting compensation and O&O expenses caps based on sales made under a particular registration statement. Generally, REITs and BDCs have ongoing O&O expenses; however, the bulk of expenses is expended at the time of the initial launch of the vehicle. This makes the first 3 years of a life of a DPP vehicle particularly vulnerable to violating the 15% O&O expenses cap especially in a soft economy. What can a DPP do if it approaches 15% compensation cap? Can it delay calculating 15% cap until later time? We believe in a perpetual-life vehicle the expense and compensation caps should not be calculated every 3 years since the offerings are ongoing. Would it be reasonable to calculate the maximum O&O expenses based on the amount registered on S-11 or N-2 rather than the amount sold in 3-year period? What if all expenses are borne by the advisor or another affiliate of a DPP until future event that triggers reimbursement. Can O&O expenses be calculated then since until the trigger event the expenses are not borne by investors (in terms of NAV per share). If all expenses are borne by a sponsor/affiliate until future date and after that date a DPP reimburses a portion of expenses each year for a period of several years, can the DPP count only the reimbursed portion as O&O expenses for that year? How often should DPP calculate its O&O expenses, every year or every 3 years?

Since underwriting compensation is generally a percentage of sales, it's not as likely that the underwriting compensation will exceed 10% in bad economy. However, it is possible. What are DPPs options if underwriting compensation reaches 10%? A DPP can stop collecting trail fees but they can't stop paying salaries to registered representatives of an affiliated broker-dealer. What if underwriting compensation in a first 3-year period (life of a registration statement) is 6% but in a second three-year period it's 11% -- can compensation be calculated as an average of six years or must underwriters calculate compensation only based on sales made under a certain registration statement? How often should underwriting compensation be calculated? Every quarter? Every year? Every 3 years? Is there a grace period between the initial launch of a DPP and when a DPP should start counting underwriting compensation and O&O expenses?

Under Rule 2310(B)(4)(B)(ii) the total amount of all items of compensation from whatever source is counted towards 10% compensation cap. We believe that compensation paid to the members by a DPP adviser/affiliate out of adviser's/affiliate's fees should not be deemed underwriting compensation since neither the issuer nor the shareholders bear the expense of such payments and such payments do not impact NAV per share.

C. <u>Rule 5190</u>

Rule 5190 requires that members participating in a distribution, as defined by Regulation M, make a set of filings around the restricted period for such distribution. We have found that both the form itself and the filing guidance need updating as FINRA's guidance regarding the filing requirements dates to 2011. Therefore we request the following:

- Guidance regarding the form requirements for reporting activities by "members" v. "non-members."
    - When the form was created, it did not provide for separate fields for FINRA members with CRD numbers and participating non-FINRA member firms and, as

a result, there is confusion as to whether this section of the form was intended solely for syndicate members or if it's intended to include affiliated purchasers outside the syndicate.

- Improvements to the CRD entries.
  - As currently constructed, the field for CRD numbers of distribution participants is mandatory, but the form only allows for auto population of this information, while the rest requires manual entry. For distributions with multiple distribution participants, this disconnect leads to an increased compliance burden and error rate, as it prevents a technological barrier to automation. To address this, all mandatory fields should have the ability for manual entry or FINRA should otherwise coordinate with firms and their technology vendors to ensure systems interoperability.

- Supplemental guidance limiting the disclosure of "affiliated purchasers" to those affiliates of each distribution participant actually participating in the distribution.
  - We note that the rules and definitions appear to require the disclosure of all affiliates, regardless of whether they are participating in the distribution. In addition to being overly burdensome to the filing member firm filing the notification, especially when such firm is filing on behalf of the syndicate, we question the value of including all affiliates regardless of their participation in the distribution to either FINRA or the SEC.

- Supplemental guidance and improvements to the notification form requirements for restricted period/distribution participant triggers in connection with blocks/PIPEs.
  - We note that FAQs 1.30 – 1.32 address certain considerations in instances where an offering was commenced and completed overnight after market close or during the same day, each of which justify relying on the "later notification is necessary under specific circumstances" option for the timing entry. However, the form does not currently provide a place to indicate that the participating FINRA member is relying on this alternative timing, which results in a notice filing that appears to be violative to the examiners until the firm responds with clarification. A simple checkbox to indicate that the firm is relying on a "later notification" circumstance would correct this issue.

- Supplemental guidance regarding the change in Regulation M to remove the exemption for investment grade debt and its replacement by the "probability of default" exemption.

- Supplemental guidance and clarification regarding when FINRA believes that a filing is triggered.

    - We note that, as currently constructed, the form does not address when a FINRA member becomes a "distribution participant" or "prospective underwriter" for the purposes of triggering a filing. Given the uncertain nature of certain offerings, especially competitive-bid block trades, a FINRA member would not become a "distribution participant" for this purpose until its bid has been accepted by the issuer or selling stockholder. However, FINRA enforcement has taken the position that the FINRA member's first contact with the issuer or selling stockholder should be the trigger which means that the filing would be required once the FINRA member is "reasonably certain" that a bid will be accepted or an understanding relating the underwriting will be reached.

    - Under the existing FAQ guidance, timing for competitive-bid blocks would seem to fit squarely in the "later notification is necessary" category, but our understanding is that FINRA has been taking the position that the FINRA member becomes a prospective underwriter earlier and, therefore, should have filed in line with the default timing.

- Supplemental FAQ guidance regarding the restricted period/distribution participant trigger in connection with IPOs.
    - Prior to an IPO, a company would not have any trading, so it would be reasonable to read FAQ1.6 to require the notification filing for the five-day restricted period for an IPO no later than one full business day prior to that fifth day before the expected pricing date. For practical reasons, many FINRA members use the "launch" of marketing for the IPO as the trigger because that is when there is sufficient certainty to be able to input any meaningful information in the restricted period notification and to be considered a distribution participant.

- Supplemental FAQ guidance and form improvements for filings/process involving securities where the member is a market maker and needs to request excused withdrawal status.
    - Market makers are prohibited from withdrawing their quotes until they receive excused withdrawal status. For block trades and PIPEs where commencement and completion often occur in the same day, a market maker will immediately request excused withdrawal upon the acceptance of the bid and will then withdraw quotes as soon as the withdrawal is granted (often within minutes of commencement).

    - However, from FINRA's perspective, those quotes that were up prior to excused withdrawal may appear to be a Rule 101 violation. The Rule 5190 form could be clearer to flag such situations. Furthermore, FINRA and the exchanges should consider combining the withdrawal and notice processes to remove the need for separate request emails to the exchanges (outside FINRA's view) and make the process more efficient and less error prone.

* * *

The Committee greatly appreciates the opportunity to provide its comments with respect the Notice and thanks the FINRA staff for its efforts to further increase efficiency and reduce unnecessary burdens on capital formation. Members of the Drafting Committee are available to meet and discuss these matters with the FINRA staff and to respond to any questions.

Very truly yours,

Michael Arnold
Chair, Federal Regulation of Securities Committee
ABA Business Law Section

<u>Drafting Committee:</u>
Gail S. Neely
Chair, Subcommittee on FINRA Corporate Financing Rules
Pallas A. Comnenos,
Vice Chair, Subcommittee on FINRA Corporate Financing Rules
Jennie Getsin
Marcie Goldstein
Peter W. LaVigne
Tracey Russell