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March 14, 2011

Via email: pubcom@finra.org

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, D.C. 20006-1506

Re: FINRA Regulatory Notice 11-04: Private Placements of Securities: Proposed Amendments to FINRA Rule 5122

Dear Ms. Asquith:

This letter is submitted on behalf of the Securities Regulation Committee (the "Committee") of the New York City Bar Association, in response to the request for comments by the Financial Industry Regulatory Authority, Inc. pursuant to FINRA Regulatory Notice 11-04 (January 2011) (the "Notice").

Our Committee is composed of lawyers with diverse perspectives on securities issues, including members of law firms and counsel to corporations, investment banks, investors and government agencies.

The Committee supports FINRA in its efforts to combat abuses in the private placement market. The Committee believes, however, that FINRA's proposal to amend Rule 5122 (the "Proposed Amendments") represents an unwarranted expansion of FINRA's regulatory authority. The Committee further believes that the Proposed Amendments would be detrimental to the private placement market and, in particular, could adversely affect capital formation by small issuers, while failing to provide

meaningful protection to investors. Finally, we believe that the Proposed Amendments would present practical problems of implementation. We believe that FINRA currently possesses ample authority under its existing rules and regulations to combat improper practices in this market. The Committee thus respectfully urges FINRA to withdraw the Proposed Amendments in their entirety or, at a minimum, to revise them so as to address the concerns expressed below.

OVERVIEW OF THE PROPOSED AMENDMENTS

FINRA Rule 5122, which became effective on June 17, 2009 (less than two years ago), regulates so-called "member private offerings," which are defined as private placements of unregistered securities issued by a FINRA member (or a control entity) in which the FINRA member or an associated person thereof offers and sells the securities being offered. Recognizing the potential conflict of interest inherent in such offerings, the Rule imposes certain disclosure, filing and other obligations on the FINRA member, including restrictions upon the use of proceeds from such offerings.

FINRA proposes amending Rule 5122 so that it would apply to a much wider array of private placements. Subject to certain exceptions, all private placements of securities in which a FINRA member or associated person "participates" (a term that is very broadly defined) would be subject to Rule 5122 as proposed to be amended.

ANALYSIS OF THE PROPOSED AMENDMENTS

THE PROPOSED AMENDMENTS EXCEED THE SCOPE OF FINRA'S AUTHORITY

The Committee believes that the Proposed Amendments exceed the scope of FINRA's delegated authority because they substantively regulate the conduct of issuers that are not registered broker-dealers or otherwise FINRA members. As a registered national securities association within the meaning of Section 15A of the Securities Exchange Act, FINRA's rulemaking authority derives from Section 15A. Section 15A(b)(6) states that FINRA's rules must be, among other things, designed to effectively and efficiently regulate persons engaged in "facilitating transactions in securities," *i.e.*, broker-dealers and their associated persons. Section 15A also makes reference to FINRA's mission to promote the public interest and protect investors.

The courts have made clear that "'public interest' is never an unbounded term. . . . [B]road 'public interest' mandates must be limited to 'the purposes Congress had in mind when it enacted [the] legislation.'"[1] Section 15A of the Exchange Act was designed to allow the SEC to delegate limited regulatory authority to national securities associations, such as FINRA, to regulate the conduct of their members—not the conduct of unrelated third parties that transact business with such members.

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[1] *The Business Roundtable v. Securities and Exchange Comm.*, 905 F.2d 406, 413 (D.C. Cir. 1990) (*quoting NAACP v. FPC*, 425 U.S. 662, 670 (1976)); *see also Aaron v. Securities and Exchange Comm.*, 446 U.S. 680, 695 (1980) (holding that "generalized references to the remedial purposes of the securities laws will not justify reading a provision more broadly than its language and statutory scheme reasonably permit" (quotation marks omitted)).

The Proposed Amendments place FINRA in the role of substantively regulating unrelated third parties by imposing restrictions on the use of proceeds by issuers that are not FINRA members (or their controlled entities). For example, if a FINRA member participates in the private placement, the Proposed Amendments would prohibit the private placement issuer from using less than 85% of the offering proceeds for the business purposes disclosed in the offering document.[2] In addition, the offering document created and used by the issuer to sell its securities would be required to contain certain prescribed disclosures.[3] In this way, the Proposed Amendments go beyond the regulation of broker-dealers by substantively regulating the conduct (*i.e.*, use of proceeds) and disclosure (*i.e.*, disclosure of use of proceeds) of non-member issuers engaged in private placement transactions in which a FINRA member participates.[4]

In sum, FINRA's rulemaking authority is statutorily limited under the Exchange Act to its mission of regulating its broker-dealer members. Regulation of issuers, and markets more broadly, remains vested with the SEC. Whereas Rule 5122 currently only regulates broker-dealers and their control entities, under the Proposed Amendments, the Rule would have the effect of regulating *all* issuers selling unregistered securities in private placements, provided a FINRA member participates. In enacting Section 15A of the Exchange Act, Congress did not contemplate that FINRA's rulemaking authority would extend this far. The Committee thus respectfully submits that the Proposed Amendments exceed the scope of authority delegated to FINRA pursuant to Section 15A(b)(6) of the Exchange Act, and for that reason should not be adopted.

THE NEED FOR THE PROPOSED AMENDMENTS SEEMS QUESTIONABLE

Current Rule 5122 is narrowly tailored to mitigate the conflicts of interest inherent in private placements in which the FINRA member (or control entity) is both the issuer and placement agent. Where the FINRA member (or control entity) is on both sides of the same transaction, potential conflict of interest issues may arise, for example, in connection with the negotiation of selling commissions and the disclosure by the FINRA member (or control entity) of such commissions. Rule 5122 properly attempts to bring to light and mitigate those inherent conflicts. The Proposed Amendments would regulate the conduct of issuers of private placement securities even where there is no inherent conflict of interest between the issuer and the broker-dealer handling the sale. It appears to us that FINRA members (and their control entities), when participating in private placements with non-FINRA affiliated issuers, are not subject to any conflicts of interest of the type that Rule 5122 was designed to address.

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2 Rule 5122(b)(3) as proposed to be amended.

3 Rule 5122(b)(1)(A) as proposed to be amended.

4 To the extent that FINRA's current rules mandate disclosure in offering documents, those mandates relate exclusively to disclosures regarding FINRA members. *See* NASD Rule 2720(a), requiring prominent disclosure in the offering document of any conflict of interest of any FINRA member that participates in a public offering and, if relevant, of the presence of a qualified independent underwriter; FINRA Rule 5122 (current version), which, as discussed herein, requires disclosure by an issuer only to the extent it is a FINRA member or an associated person thereof.

To support the proposition that the Proposed Amendments are necessary, FINRA cites in the Notice several enforcement actions recently brought by the SEC and FINRA.[5] These actions involved individuals or entities committing fraud on investors by, for example, making material misstatements and omissions about an investment's risks and likely returns, misappropriating funds from investors, commingling funds and engaging in classic Ponzi schemes. All of the cited cases involve clear violations of the SEC's anti-fraud rules, which already apply to private placement issuers. The Notice does not explain, and we don't understand, how any of the investor losses discussed in these cases would have been prevented if the Proposed Amendments had been in place.

For example, the implicit cap on compensation to FINRA members and other offering expenses set forth in the Proposed Amendments would not prevent deceitful issuers from defrauding investors. Similarly, the requirement that issuers disclose in their offering documents an intended use of proceeds and that 85% of such proceeds be used for such disclosed purposes will not hinder "bad actor" issuers from putting those proceeds to some other use. The Proposed Amendments would also require disclosure of private placement investment banking fees, which are typically kept confidential, even though the Notice does not discuss any abuses arising from this custom or explain how disclosure would combat the fraud FINRA is trying to prevent.

FINRA has recently published guidance regarding a broker-dealer's obligation under federal securities law to conduct a reasonable investigation of an issuer and the securities the broker/dealer recommends in Regulation D offerings.[6] That guidance does not seek directly to regulate the conduct of non-member transaction participants, but instead is properly directed toward FINRA members. FINRA rules also require members to have a reasonable basis for recommending a security to a customer.[7] Due diligence and suitability are well understood concepts developed over decades of practice. We respectfully submit that if any of the FINRA members identified in the enforcement proceedings cited in the Notice were viewed as having failed properly to discharge their due diligence or suitability obligations, FINRA currently possesses the necessary authority to investigate the transactions at issue and, if determined to be appropriate, to sanction such members.

It is perfectly appropriate for FINRA to focus on fraud on investors. Unfortunately, the Committee believes that the Proposed Amendments will not enhance the ability of FINRA (or the SEC) to root out this fraud. Yet the Proposed Amendments would cause private placements to become more expensive and take longer to execute, creating added risk and uncertainty for transaction participants while not increasing investor protection.

THE PROPOSED AMENDMENTS WOULD LEAD TO RULE 5122 ENFORCEMENT QUESTIONS AND PROBLEMS

The Proposed Amendments would lead to several significant enforcement issues. Most importantly, the Proposed Amendments would (i) place an onus of compliance on FINRA members for conduct of third-party issuers they do not control, (ii) create uncertainty for transactional participants and (iii) fail to provide any viable remedies for violations.

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5 Notice, at pg. 6 (n. 4) and pg. 7 (n. 13).

6 FINRA Regulatory Notice 10-22 (April 2010).

7 NASD Rule 2310(a).

The Notice states that under Rule 5122 as currently in effect, the FINRA staff conducts *ex post* reviews of offering documents to "assess compliance" with the rule. The Notice further states that "[a]s under the current rule, the filing requirement would not impose any delay in the offering."[8] FINRA staff would review such filings and "identify problematic terms and conditions," and FINRA staff may request additional information regarding the issuer's use of proceeds or related information. The Proposed Amendments further state that if a FINRA member (or associated person) discovers that a private placement did not comply with the rule, the FINRA member "must promptly conform the offering" to remedy the non-compliance.[9] We believe that the lack of clarity on the timing of FINRA staff review of filings, how problematic terms are to be modified, how FINRA members can ensure issuer compliance with mandates of the rule, the extent of FINRA members' obligation to do so, and how non-compliance is to be remedied after a successful private placement closing would create uncertainty in the private placement market.

What would occur if, for example, during an *ex post* review of offering documents to assess compliance with the Proposed Amendments and to identify problematic terms and conditions, FINRA identifies potential issues? The Proposed Amendments do not supply any guidance. Unwinding the transaction seems out of the question, given the cost and upset contractual expectations involved. Sanctioning the FINRA member(s) that participated in the offering also seems inappropriate, as it would render FINRA members guarantors of compliance by their clients.

These issues are perhaps best demonstrated by the following hypothetical scenarios. This is not a complete listing of all possible enforcement issues that could be created by the Proposed Amendments.

- *Scenario #1* -- FINRA requests additional information about a private placement offering from the FINRA member after closing of the offering.[10] However, the FINRA member is unable to comply, as it does not possess the requested information and the issuer refuses to provide it. What is the remedy?

- *Scenario #2* -- If the FINRA member obtains a covenant from the issuer to provide additional information to the member post-closing in the event FINRA requests such information, but the issuer fails to produce the information upon request, is the FINRA member required to litigate to enforce the covenant?

- *Scenario #3* -- With the same facts as Scenario #2, the FINRA member cannot obtain the information from the issuer, and FINRA subsequently determines that the offering

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8 Given the number of filings that FINRA would receive under the Proposed Amendments, the Committee would not expect FINRA to have the resources to conduct these reviews on a timely basis. We note, however, that the Notice does not expressly state that all reviews of filings made pursuant to the Proposed Amendments would be made on an *ex post* basis. In fact, the Notice suggests that a filing under the Proposed Amendments would be reviewed during the pendency of the offering ("The offering may proceed while FINRA staff reviews the offering document."). Notice, pg. 4.

9 Rule 5122(b)(4) as proposed to be amended.

10 We note that the request would have to be directed to the FINRA member. FINRA has no authority to compel the non-member issuer to provide it with information.

violated Rule 5122. Is the FINRA member deemed responsible for this violation? If so, what is the remedy?

- *Scenario #4* -- A FINRA member obtains a covenant from the issuer that the issuer will use at least 85% of the gross offering proceeds for the business purposes set forth in the offering document. The issuer subsequently violates the covenant. Is the FINRA member in violation of the Proposed Amendments? If so, what is the remedy?

- *Scenario #5* -- The issuer incurs offering costs and compensation expense in connection with the private placement in excess of 15% of the gross proceeds of the offering, and covenants to the FINRA member that it will obtain the funds needed to pay the amount in excess of the 15% threshold from funds other than those raised in the offering. Does the FINRA member have to police compliance with this covenant? If so, given the fungibility of money, how could the member do so? Alternatively, if the member may accept the covenant on its face, how are the goals underlying the Proposed Amendments advanced?

As the foregoing scenarios demonstrate, the Proposed Amendments would appear to place FINRA members in the untenable position of being responsible to FINRA for breaches, but without the ability to ensure compliance, or in some cases even monitor it. The regulatory uncertainty that this would create has the potential to interfere with the raising of capital in private placements by a wide range of issuers.

THE PROPOSED AMENDMENTS DISADVANTAGE ACCREDITED INVESTORS AND ISSUERS THAT RELY ON THE PRIVATE PLACEMENT MARKET

While the Proposed Amendments would exempt private placement offerings to various types of investors, conspicuously absent from the list are accredited investors. The exemptions set forth in the Proposed Amendments include institutional accounts (as defined in FINRA Rule 3110(c)(4)), qualified purchasers (as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940), qualified institutional buyers (as defined in Rule 144A under the Securities Act) and investment companies and banks. However, the Proposed Amendments would apply to private placement offerings made to accredited investors (institutional and individual) when the offerees do not meet the higher standards of one of these exempted categories.

As FINRA is well aware, private placements to accredited investors are an important source of funding to start-up and other smaller companies, including funding arranged by venture capital fund sponsors. They are also an important component of the business plans of many smaller broker/dealers that are FINRA members. There is a risk that the Proposed Amendments will introduce regulatory uncertainty into such offerings, making them more difficult to complete, and thus less attractive to transaction participants. This would compromise an important source of funding for smaller companies, which typically lack many of the financing options available to larger companies.

In addition, the Proposed Amendments appear to provide that if a single purchaser in the offering proves to be a mere accredited investor (even though the FINRA member reasonably believed the purchaser to be an exempt person at the time of the purchase and sale), the exemption from the Proposed Amendments would be lost. This may, in effect, lead issuers and placement agents to bar accredited investors that do not also qualify for an exempted category from their offerings, rather than risk compromising the offering by inadvertently including an accredited investor who failed to also meet one of the exempted categories.

As noted above, it is unclear whether any FINRA staff review of private placement offering documents filed pursuant to the Proposed Amendments would take place prior to the closing of the offering. If this is possible, additional uncertainty would be introduced into such offerings, as transaction participants would be at risk of delay in the transaction if FINRA staff identified any potential issues in a pre-closing review. This delay could result in failure to consummate the transaction, as offering windows are often of brief duration, particularly in volatile markets.

There is also the related risk that private placements would be structured to exclude non-exempt accredited investors, either by excluding them from domestic offerings or by moving the transaction to offshore markets. This would remove a potentially attractive investment opportunities from a portion of the market that the SEC has determined is sufficiently sophisticated to fend for itself.

THE APPLICATION OF THE PROPOSED AMENDMENTS TO M&A AND OTHER TRANSACTIONS IS UNCLEAR

FINRA has not specified the extent to which the Proposed Amendments would apply to an M&A transaction structured as a stock sale, either for cash or for acquirer stock. Although such a transaction typically is exempt from registration under Section 5 of the Securities Act, it is still a sale of stock for other purposes of the federal securities law.[11] The Proposed Amendments would also replace "offer or sell" in the lead-in to Rule 5122(b) with "participate," which term is defined by reference to FINRA Rule 5110(a)(5). Rule 5110(a)(5) defines participation very broadly, causing the Proposed Amendments to implicate various advisory and other peripheral roles played by FINRA members.[12]

M&A transactions should not be covered by Rule 5122 as proposed to be amended. FINRA's rationale for expanding the rule is tied to capital raising transactions, and various aspects of the Proposed Amendments simply do not work in the context of M&A transactions.

First, the concept of "use of proceeds" is inapposite in a transaction that does not involve capital raising. In addition, it is unclear how one would apply the Proposed Amendments to a stock-for-stock deal in which there are no "proceeds" and, therefore, no description of the uses of those proceeds. The Proposed Amendments also appear to require disclosure -- at least to FINRA -- of the fees paid to the FINRA members by the parties in an M&A transaction. We do not understand how the 15% cap on fees

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11 *See, e.g., Gustafson v. Alloyd*, 513 U.S. 561 (1995).

12 FINRA Rule 5110(a)(5) defines "participation" as:

> Participation in the preparation of the offering or other documents, participation in the distribution of the offering on an underwritten, non-underwritten, or any other basis, furnishing of customer and/or broker lists for solicitation, or participation in any advisory or consulting capacity to the issuer related to the offering, but not the preparation of an appraisal in a savings and loan conversion or a bank offering or the preparation of a fairness opinion pursuant to [Exchange Act] Rule 13e-3.

That fairness opinions provided in a Rule 13e-3 context are specifically excluded from the definition of "participation" suggests that a FINRA member's provision of a fairness opinion (or otherwise being retained) in a context *other than* a Rule 13e-3 transaction would, in fact, constitute participation for purposes of the Proposed Amendments.

and other transaction expenses would apply in this context. And, as FINRA is aware, it is not customary in M&A transactions for FINRA members to disclose their fees. Such information may be considered to be competitively sensitive by FINRA members.[13] Given that this is the well-established market norm, we submit that FINRA should only require such disclosure if it can demonstrate a clear need, which we don't see here.

Finally, given the breadth of the proposed definition of "participation" in the Notice, it is also possible that the Proposed Amendments could apply to transactions other than capital markets or M&A transactions, including, for example, structured financings, sales in the term loan market and secondary trading of loans.[14]

SPECIFIC SUGGESTIONS SHOULD FINRA ELECT TO AMEND RULE 5122

As noted above, we do not believe that FINRA should proceed with the Proposed Amendments. If FINRA does proceed to expand the scope of Rule 5122 beyond member private offerings, the Committee respectfully recommends that FINRA make the following changes to the Proposed Amendments:[15]

- Clarify that FINRA members may proceed with private placement offerings exempt from Rule 5122 so long as they have a reasonable belief as to the exempt status of the purchasers. We note that addition of this "reasonable belief" standard would align the rule with the SEC's standards for determining whether a prospective investor is an accredited investor, qualified institutional buyer or qualified purchaser.[16]

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[13] Even if fee disclosure is made solely to FINRA on a confidential basis, as FINRA proposes in the Notice, the information may be subject to discovery in litigation pursuant to a properly-framed subpoena, since FINRA, as a private entity, does not enjoy the same protection from litigation as does the SEC. This risk could result in forced disclosure of confidential information without the issuer or FINRA member being afforded any opportunity to contest the disclosure. We thus do not believe that FINRA will be able to ensure that the confidentiality of this information will be protected. As noted above, FINRA members may also have confidentiality concerns regarding disclosure of private placement fees in offering transactions.

[14] *See, e.g., Reves v. Ernst & Young*, 494 U.S. 56 (1990) (notes issued by farmers' cooperative associations, and similar publicly distributed unsecured demand notes, held to be securities for purposes of the Securities Act and the Exchange Act). The question of when certain evidences of indebtedness constitute securities for purposes of the Securities Act is particularly uncertain. *See, e.g., Pollack v. Laidlaw Holdings, Inc.*, 27 F.3d 808 (2d Cir. 1994) (mortgage participations held to be securities); *but see Banco Expanol de Credito v. Security Pacific Nat'l Bank*, 973 F.2d 51 (2d Cir. 1992), *cert. denied* 113 S.Ct. 2992 (1993) (loan participations marketed only to institutional entities via individualized presentations held not to be securities). To the extent such a transaction were deemed to involve a security, a resale thereof would likely constitute a private placement and would, if a FINRA member were to participate, thus be subject to the filing and other obligations of Rule 5122 as proposed to be amended. The Committee believes this is a particularly unworkable outcome.

[15] To the extent these comments relate to provisions currently contained in Rule 5122, we recommend that FINRA make the suggested change for all purposes under Rule 5122.

[16] See Securities Act (Regulation D) Rule 501(a) (regarding accredited investors), Securities Act Rule 144A(d)(1) (as to qualified institutional buyers) and Investment Company Act Rule 2a51-1(h) (as to qualified purchasers).

- Clarify that a member firm would be in violation of the rule only if the member knew or should have known by performing a reasonable inquiry at the time of the offering, that an issuer's representations or offering document disclosures were not accurate when they were made or issued.

- Exempt private placement offerings in which a high percentage of the gross proceeds of the offering, but less than all, is purchased by exempt purchasers. The Committee suggests that 80% would be an appropriate threshold.[17]

- Limit application of the rule to transactions in which a FINRA member (or a control entity of a firm) offers or sells the securities, or is itself the issuer. The concept of "participation" is too broad for use in this rule.[18]

- Rather than requiring that a certain portion of proceeds be used for disclosed business purposes, any such limitation should be recast as a limitation on the amount of placement fees a FINRA member may receive (whether directly or as a discount). FINRA members could verify compliance with an implicit cap on placement fees, as they would know what they were paid. They would not be able verify compliance with a requirement that also limits offering costs, as that information is within the control of the issuer.

- Clarify that Rule 5122 only applies to capital raising transactions, not to M&A and other transactions involving securities.

- Clarify that the Proposed Amendments only apply to issuer private placements, and not to secondary transactions effected privately.

- Clarify that an offering to more than one category of exempt investors as identified in Rule 5122(c)(1) would be exempt, notwithstanding the use of the word "solely" in that sub-section.

- Add institutional Accredited Investors[19] to the categories of exemptions under subparagraph (c) of Rule 5122 as proposed to be amended. The Committee believes that this group of investors possesses the requisite sophistication so as to not require the protections sought to be provided by the Proposed Amendments.[20]

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17 We believe that any such *de minimis* exception should be calibrated to the gross proceeds of the offering and not the number of offerees or purchasers. In a private placement involving a small number of purchasers, inadvertent inclusion of a single accredited investor who fails to meet any of the standards for exemption from Rule 5122 could constitute a greater than *de minimis* percentage of the total number of offerees or purchasers.

18 The Committee believes this comment is merited even if FINRA agrees to expressly limit the scope of the rule to capital raising transactions, as FINRA members could have roles in such a transaction that do not involve offering and selling the offered securities.

19 As defined in Rule 501(a)(1), (2) or (3) of Regulation D.

20 We acknowledge that this proposal would disadvantage accredited investors that are not institutions, and that such accredited investors are also presumed under federal securities law to possess sufficient sophistication to

(continued...)

- Expand the exemption for qualified purchasers to include "knowledgeable employees" and other persons that are excluded from the definition of qualified purchaser contained in Section 3(c)(7) of the Investment Company Act of 1940 pursuant to Rule 3c-5(b) thereunder.[21]

- Clarify that subsection (c)(10) of the Proposed Amendments (current Rule 5122(c)(11)) exempts securities exchanged by an issuer with its existing security holders in accordance with Section 3(a)(9) of the Securities Act.

- Delete "or its control entities" from Rule 5122(c)(9) (as proposed to be amended). The definition of "control entity" appears in current Rule 5122(a)(2), but that subsection is proposed to be deleted from the amended Rule, and the concept is not needed given the reference to affiliates of the issuer in proposed subsection (c)(9).

- Clarify that the exclusion for offerings made pursuant to Rule 144A under the Securities Act (Rule 5122(c)(3)) applies to both the initial private placement between the issuer and the initial purchaser(s), as well as the subsequent placement by the initial purchaser(s) to their clients.

- In proposed subsection (c)(11), change the reference to Section 1a(5) of the Commodity Exchange Act to Section 1a(11) to conform to renumbering effected by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

CONCLUSION

In conclusion, the Committee believes adoption of the Proposed Amendments would be detrimental to the private placement market, provides no substantial additional protection to investors, and present insurmountable issues in respect of implementation, compliance and enforcement. The Committee therefore urges FINRA to abandon the Proposed Amendments in their entirety.

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participate in private placements. We believe that this proposal, while an improvement to the Proposed Amendments, would still be a suboptimal outcome from a policy point of view, and that these policy concerns and regulatory inconsistencies support our primary recommendation that FINRA not proceed with the Proposed Amendments.

21 See Rule 3c-5(a)(4) under the Investment Company Act of 1940 for the definition of the term "knowledgeable employees."

Thank you for your time and consideration.

Very truly yours,

Robert E. Buckholz
Chair
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