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March 14, 2011

***Via email to pubcom@finra.org***

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

**Re:** ***Regulatory Notice 11-04***

Dear Ms. Asquith:

Pursuant to FINRA's request, this correspondence represents comments by member firm Walton Securities, Inc. (CRD #143763) regarding FINRA's proposed amendments to Rule 5122 as described in Regulatory Notice 11-04 published on January 11, 2011.

By way of background, Walton Securities, Inc. ("***WSI***") is a wholesale broker-dealer in the business of managing selling groups for the private placement investment programs (sold to only accredited investors) of its affiliated sponsor, Walton International Group (USA), Inc. All of the private placement offerings anticipated by WSI relate to the acquisition of land in the path of development growth, and the subsequent entitlement of that land to its "highest and best" use in order to be "shovel ready" at the time that growth advances to the property. In an environment in which bank financing has contracted significantly, WSI believes that private capital formation is an essential component of real estate financing in the wake of the real estate market correction.

For the purposes of this comment letter, it is important to note that the assets in WSI managed investment programs are <u>not</u> intended to and do <u>not</u> provide cash flow during the investment hold period. Accordingly, as applied to WSI, FINRA's proposed amendments to Rule 5122 present unique challenges to this asset class as described below.

## A. Executive Summary

FINRA specifically requested comments on whether the proposed amendments adversely affect "the types of private placements that generally have not presented investor protection concerns." WSI respectfully submits that private placements with full and accurate disclosures have not presented investor protection concerns.

Accordingly, WSI ***supports*** the proposed amendments as they relate to mandatory, full disclosure of <u>any</u> type of compensation whether paid directly or indirectly to a participating member firm and/or its associated persons.



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WSI further ***supports*** FINRA's proposal of pre-filing offering memoranda as a method to ensure member firms' compliance with existing regulations.

Notwithstanding the foregoing, WSI respectfully requests that FINRA not amend Rule 5122 as proposed in Sections 5122(b)(3) and 5122(c). Investment sponsors of non-cash flowing asset programs that offer private placements through affiliated wholesale broker-dealers must be able to earn program management fees and recover costs associated with offering those investment programs in order to perform their duties as managers in the best interests of their investors. For the reasons discussed below, limiting the proposed amendments to Rule 5122(b)(1), (2) and (4) are sufficient to address investor protection concerns.

**B. Walton Securities, Inc. supports the proposed amendments as they relate to <u>increased disclosure</u> *and* <u>pre-filing</u> of offering memoranda.**

As an initial matter, WSI understands the importance of and supports the stated policies of FINRA's proposed amendments to (a) achieve investor protection and (b) provide a response to recent abuses in the sale of private placements. Accordingly, WSI ***supports*** the proposed amendments as they relate to mandatory, full disclosure of <u>any</u> type of compensation, whether paid directly or indirectly to a participating member firm and/or its associated persons.

WSI further ***supports*** FINRA's proposal that all offering memoranda be pre-filed with FINRA as a method to ensure member firms' compliance with existing regulations. Indeed, as a matter of practice, WSI already submits to FINRA's offices in Rockville, Maryland all offering memoranda in respect of which WSI serves as managing broker-dealer and does so at the same time it submits marketing materials for FINRA review related to said offerings. [1]

WSI believes that these amendments are positive steps taken by FINRA in its ongoing efforts to provide additional protection for private placement accredited investors. WSI supports these portions of the amendments as drafted. As shown below, WSI respectfully requests that FINRA reconsider the remaining portions of the proposed Rule.

**C. The proposed 15 percent limitation on broker-dealer and associated person compensation disadvantages non-cash flowing investment managers as well as smaller investment managers**.

As proposed for amendment, Rule 5122(b)(3) would read as follows:

"(3) Use of Offering Proceeds: For each [Member Private Offering] <u>private placement</u>, at least 85% of the offering proceeds raised [must] <u>may not</u> be used [for business purposes, which shall not include] <u>to pay for</u> offering costs, discounts, commissions, [<u>or any other</u>

[1] Under proposed Rule 5122, the filing of offering memoranda contemporaneously with corresponding marketing materials would optimize efficiency on a prospective basis. In this regard, only the managing broker-dealer would need to file with FINRA, not every selling group member. Regardless of the logistics, requiring all selling group members to file with FINRA would result in unnecessary duplication, confusion and generate waste.



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> cash or non-case sales incentives] and any other compensation to participating broker-dealers or associated persons, and must be used for the business purposes required to be disclosed by paragraph (b)(1)(A)(i). [The use of the offering proceeds also must be consistent with the disclosures required in paragraph (b)(1)]"

The proposed amendment to Rule 5122(b)(3) thereby limits use of the offering proceeds to pay for all compensation to participating broker-dealers and associated persons to a maximum of 15 percent. With the proposed elimination of the current wholesale broker-dealer exemption in Rule 5122(c)(4), it is unclear whether this limitation includes a limit on overall program compensation to affiliated sponsors of wholesale broker-dealers.[2]

If affiliated sponsors of non-cash flowing investment programs are included in the definition of "associated persons", then the proposed amendment would include, within the 15 percent limitation, amounts set aside from the offering proceeds for uses such as: (1) acquisition/disposition fees; (2) asset management fees; and/or (3) cost recoveries. By way of example, if a wholesale broker-dealer managed a selling group with an industry standard 11 percent in external distribution costs (covering registered representative selling commissions, selling group marketing and due diligence expenses and offering and organizational expenses) *and* an affiliated sponsor charged a 1% asset management fee during a five year program hold period, then such member firm would be in violation of the proposed amended Rule. WSI does not believe that FINRA intended such an anomalous result.

Even if affiliated sponsors are not included in the definition of "associated sponsors", by replacing the selling compensation limitation with a limitation on "any compensation", the proposed Rule has been extended to cover amounts properly in the purview of general and administrative operating expenses. For example, if a sponsor's Chief Financial Officer is also the licensed Financial Operative of the affiliated wholesale broker-dealer, the CFO's salary received from the non-member affiliate would be subject to the 15 percent limitation under the proposed Rule even though the CFO played no role in the selling of a program's securities. This anomaly has been historically corrected by the wholesale broker-dealer exemption and provides a sound basis for such an exemption.[3] By eliminating the wholesale broker-dealer exemption and revising the compensation limitation, the proposed Rule discriminates against non-cash flowing asset managers and small businesses.

[2] Because Article I(rr)(3) of FINRA's By-Laws of the Corporation as published in the June 2010 FINRA Manual does not limit "associated persons" to "natural persons" as is the case in Article I(rr)(1) and (2), it appears that affiliated sponsors are included in the definition of "associated persons" if listed in Schedule A of a member's Form BD.

[3] WSI also believes that the extra layer of investor protection gained from the distribution of private placements through independent broker-dealers remains persuasive as a reason for the continuation of the exemption, especially in light of the increased disclosure requirements of the proposed Rule. *See* Regulatory Notice 09-27 at p.5.



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1. Proposed Rule 5122(b)(3) inappropriately provides competitive advantages to member affiliate cash flowing investment managers

Asset managers of non cash-flowing programs must, by necessity, pay for operating expenses from the offering proceeds. There exists no other source of capital (without additional and repetitive capital calls) during the investment hold period. By contrast, member affiliate cash flowing investment managers would be unaffected by the proposed Rule because they could use annual cash flows to pay operating expenses and thereby utilize a greater percentage of the proposed 15 percent limitation for selling compensation. As written, the proposed amendment would have the detrimental effect of making it more difficult for asset managers of non-cash flowing investments to raise capital through affiliated member firms than for cash-flowing investment managers. It is therefore contrary to FINRA's directive that its rules must ***not*** be designed:

. . . to permit unfair discrimination between customers, issuers, brokers, or dealers, to fix minimum profits, to impose any schedule or fix rates of commission, allowances, discounts, or other fees to be charged by its members, or to regulate by virtue of any authority conferred by [the 1934 Act] matters not related to the purposes of [the 1934 Act] or the administration of the association.

*See* Section 15A(b)(6) of the Securities Exchange Act of 1934.[4]

2. Proposed Rule 5122(b)(3) inappropriately provides competitive advantages to larger capital raising firms.

Not only does the proposed Rule as written prevent non-cash flowing asset managers from competitively recovering costs, but by imposing a "one size fits all" percentage limitation, the proposed Rule also would have a greater adverse impact on small businesses – irrespective of the asset class of the investment program. Certain distribution costs are fixed. Whether the investment program is raising $1 billion per year or $30 million per year through independent broker-dealers, certain costs in reaching advisors in a selling group network spanning the fifty states are essentially the same.[5] Therefore, a flat percentage limitation on all capital raising entities would necessarily have a greater impact on smaller businesses because the same fixed costs would be a greater percentage in relation to the smaller proceeds raised. Similar to how a flat federal income tax has a greater impact on lower wage earners, the resulting system would unfairly favor the largest asset managers in the industry and create oppressive barriers to entry.

Smaller capital raising firms with affiliated wholesale broker-dealers would also be disadvantaged in competitively staffing its member firm. For example, if a wholesale broker-dealer raises $1 billion in capital per year out of ten distinct sales regions in the United States and

[4]The proposed Rule may also have the effect of disincenting affiliate sponsors of wholesale broker-dealers from licensing its administrative employees, since those employees would be counted against the proposed 15 percent limitation even if they did not participate in the sale of the securities.

[5] *See, e.g.*, Notice to Members 83-15 and Notice to Members 92-53.



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compensates its wholesalers per region at a sales commission of 1%, that wholesaler would make approximately $1 million per year. By contrast, if a smaller firm that raises $30 million per year has the same compensation structure as dictated by a flat percentage limitation, its wholesaler would make only $30,000 per year. It would therefore be much more difficult for that smaller capital raising firm to attract quality personnel. The larger firms would have a distinct competitive advantage in the market place to the detriment of smaller firms. Clearly, the proposed 85 percent limitation "imposes an unnecessary burden on smaller private placements."

As demonstrated, not all asset classes and not all asset managers are alike. Investment sponsors of non-cash flowing asset programs that offer private placements through affiliated wholesale broker-dealers must be able to recover costs associated with offering those investment programs in order to perform their duties as managers in the best interests of their investors. It follows that such managers should not be penalized as a result of their underlying asset or because of the size of their capital raising abilities.

FINRA publicly acknowledges the importance of small business private capital formation through the independent broker-dealer distribution channel.[6] We do not believe that FINRA intended to favor certain firms just because of their size or their underlying asset. Therefore, in order to avoid a chilling effect on the small capital formation sector of the American economy *and* the potential for industry job loss consequences from the proposed Rule, WSI strongly suggests that FINRA either (a) not eliminate the wholesaling exemption under Rule 5122(c) or (b) eliminate the 15 percent compensation limitation that affects the ability of private placement sponsors to remain viable business entities.

**D. Increased disclosure requirements, pre-filing, Regulatory Notice 10-22 and the plethora of increased regulation as a result of Dodd-Frank are sufficient for the protection of accredited investors.**

As a general observation, the proposed amendment to Rule 5122(b)(3) appears to be a reaction to disclosure failures/deficiencies by member firms. *See* Regulatory Notice 11-04, notes 4, 10 (regarding material omissions related to the use of proceeds). As stated above, WSI fully supports FINRA's regulations concerning disclosure of any compensation to member firms and their associated persons. By eliminating the word "selling" from the disclosure requirement in Rule 5122(b)(1)(ii), FINRA appears to have sufficiently amended the Rule in furtherance of its goal to protect investors from a replication of historic disclosure deficiencies.

The strength of the regulatory structure, with the proposed additional disclosure and pre-filing requirement, is buttressed by FINRA's Regulatory Notice 10-22 published in April 2010. In that Notice, FINRA reminded member firms of their due diligence obligations in connection

[6] An unintended consequence of this proposed Rule is that program sponsors may elect not to use regulated, member firms for sales to accredited investors and instead distribute "issuer direct" through unregulated finders. No result could be more detrimental to investor protection than to drive the small capital formation sector of the financial services industry into the unregulated arena of "finders".



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with private placements *and* the suitability of those investments for investors.[7] Moreover, changes to Regulation D as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act such as those regulations related to "bad boy provisions" and the accredited investor standard have also substantially enhanced investor protection.

In sum, the regulatory structure in place is robust. If full disclosure is made in accordance with the proposed amendment to Rule 5122(b)(1)(ii), and Regulatory Notice 10-22 is followed to ensure proper due diligence is completed on investment programs, the goal of investor protection will have been satisfied and what will remain is an accredited investor's educated and informed investment decision. There should be no need for FINRA to prohibit member participation in a private placement based on the business terms of the program as contemplated in proposed amendment Rule 5122(b)(3).[8]

WSI appreciates this opportunity to comment upon Regulatory Notice 11-04. We also appreciate FINRA's efforts to protect investors and we support the majority of the proposed amendments as outlined above. In that regard, we support the disclosure and filing amendments as proposed in Rule 5122(b)1, (2) and (4). However, we respectfully request that FINRA reconsider its proposed amendments to Rule 5122(b)(3) and Rule 5122(c). We look forward to working collaboratively with FINRA to address investor protection concerns while at the same time creating an environment that facilitates, rather than impedes, small capital formation.

Should you have any questions concerning the foregoing, or if you would care to discuss our comments, please do not hesitate to contact me.

Respectfully submitted,
WALTON SECURITIES, INC.

By: _____
Robert D. Leinbach
President

Cc: Joseph E. Price, Senior Vice President, Corporate Financing/ Advertising Regulation
Gary L. Goldsholle, Vice President and Associate General Counsel, Office of General Counsel
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[7] FINRA's regulatory structure already includes detailed suitability restrictions. *See* Regulatory Notice 11-02.

[8] In cases where private placements are offered only to suitable accredited investors (and the accredited investor standard is increasingly stringent), it does not seem appropriate for FINRA to make universal determinations regarding the use of proceeds. If all of the economics of the program are disclosed, it is properly in the purview of the suitable accredited investor to decide whether or not to invest.



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