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# Private Placement Update: FINRA Proposes Rule Amendments to Require Filings for Non-Institutional Private Placements

**Headline: FINRA has proposed expansion of Rule 5122 to apply the disclosure, use of proceeds restrictions, and FINRA notice filing requirements of that Rule to participation in all private placements, subject to that Rule's exceptions (including an exception for institutional private placements). The Rule currently places restrictions on private placements by FINRA members and control entities of FINRA members only.**

## Introduction and Overview

Recently, the Financial Industry Regulatory Authority ("FINRA") proposed significant amendments to FINRA Rule 5122 (the "Rule"),[1] which presently applies to "member private offerings". Member private offerings are private placements issued by a FINRA member or a "control entity" of the FINRA member. Current FINRA Rule 5122 provides for disclosure in offering documents, filing of offering documents with FINRA, and limitations on the use of proceeds, unless an exemption is available.[2] Under the proposed amendments, FINRA would expand the scope of Rule 5122 to all private placements and not just those where the member or a control entity is the issuer.

FINRA announced that the comment period with respect to the proposed amendments will close on March 14, 2011.[3]

[1] Rule 5122 originally became effective on June 17, 2009.

[2] See FINRA Regulatory Notice 11-04, "*FINRA Requests Comment on Proposed Amendments to FINRA Rule 5122 to Address Member Firm Participation in Private Placements*," (January 2010) (the "Release").

[3] Comments can be submitted by e-mail to pubcom@finra.org.

## Current Rule

Under the current Rule 5122, FINRA-member broker-dealers that engage in private placements of unregistered securities issued by the broker-dealer (or a control entity of the broker-dealer) must: [4]

- disclose to investors in a private placement memorandum, term sheet or other offering document the intended use of offering proceeds and the offering expenses;
- file such offering document with FINRA's Corporate Financing Department at or prior to the time it is provided to any investor; and
- commit that at least 85 percent of the offering proceeds will be used for business purposes, which shall not include offering costs, discounts, commissions and any other cash or non-cash sales incentives. [5]

Currently, FINRA Rule 5122 applies only if a FINRA member or associated person of a FINRA-member "offers or sells" any securities in FINRA member private offerings.

The current rule is subject to certain exemptions found at FINRA Rule 5122(c).

The exemptions include, among others:

- offerings sold solely to: (A) institutional accounts; (B) qualified purchasers;[6] (C) qualified institutional buyers; (D) investment companies; (E) an entity composed exclusively of qualified institutional buyers; and (F) banks;
- offerings made pursuant to Securities Act Rule 144A or SEC Regulation S;
- offerings of exempt securities with short term maturities under Section 3(a)(3) of the Securities Act;
- offerings of unregistered investment grade rated debt and preferred securities;
- offerings to employees and affiliates of the issuer or its control entities;
- offerings of securities issued in conversions, stock splits and restructuring transactions that are executed by an already existing investor without the need for additional consideration or investments on the part of the investor;
- offerings of equity and credit derivatives, including OTC options; provided that the reference entity is not the member or any if its control entities; and
- offerings filed with FINRA under Rules 2310, 5110 or Rule 5121.[7]

[4] Currently, the term "control" means beneficial interest, as defined in Rule 5130(i)(1), of more than 50 percent of the outstanding voting securities of a corporation, or the right to more than 50 percent of the distributable profits or losses of a partnership or other non-corporate legal entity. Control will be determined immediately after the closing of an offering, and in the case of an offering with multiple intended closings, immediately following each closing. See Rule 5122(a)(4).

[5] We note that this provision of the Rule effectively creates a maximum level of broker-dealer compensation for those private placements to which it applies. In this way the Rule is akin to Rule 5110, which measures and prohibits unreasonable levels of, "underwriters' compensation".

[6] We note that the exception for private placements to "qualified purchasers" would exempt hedge, private equity, venture capital, and other private funds that are exempt from registered investment company registration by virtue of Section 3(c)(7) of the Investment Company Act. Private funds exempt by virtue of 3(c)(1) (the qualified client" standard, however, are not so exempt.

## Proposed Rule Amendments

FINRA proposes to amend Rule 5122 by expanding the scope of the rule so that it applies not only to members' private offerings but to any private placement. The proposed amendments would apply to any FINRA-member that "participates" (as defined under FINRA Rule 5110(a)(5)[8]) in a private placement. The new definition would be broader than offering or selling securities because under Rule 5110(a)(5) "participation" includes, for example, any member or associated person who provides "advisory or consulting" services to an issuer or who is involved in the preparation of the private placement memorandum, but who is not involved in the offer or sale of the securities of such private placement.[9]

In addition, under proposed FINRA Rule 5122(b)(1)(iii), the applicable private placement memorandum or term sheet must disclose, if applicable, "that the issuer and any participating broker-dealer are affiliates and the nature of the affiliation." As a result, FINRA proposes add a new definition of "affiliate" and "control", where "control" has the same meaning as set forth in FINRA Rule 5121.[10]

FINRA has also proposed to keep all of the current exemptions except for the wholesaling exemption in FINRA Rule 5122(c)(4). FINRA points out that recent enforcement cases have involved private placements in which a broker-dealer affiliated with an issuer acted primarily as the wholesaler, in FINRA's view demonstrating the need for more investor protection. Further, FINRA stated in the Release that "given that the proposed amendments expand the rule to reach all private placements, the reliance upon the efforts of an (independent) broker-dealer is no longer relevant."

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[7] Other exemptions include offerings of (i) exempted securities, (ii) subordinated loans under SEA Rule 15c3-1, Appendix D (see NASD Notice to Members 02-32 (June 2002)), (iii) "variable contracts", as defined in Rule 2320(b), (iv) modified guaranteed annuity contracts and modified guaranteed life insurance policies, and (v) securities of a commodity pool operated by a commodity pool operator. Also currently exempted is "offerings in which a member acts primarily in a wholesaling capacity (i.e., it intends, as evidenced by a selling agreement, to sell through its affiliate broker-dealers, less than 20% of the securities in the offering)" but note that the proposal described herein eliminates that exemption.

[8] Rule 5110(a)(5) defines "participation" very broadly 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 SEA Rule 13e-3.

[9] In addition, the definition found at Rule 5110(a)(5), to which reference is made in amended Rule 5122, is "participation or participating in a public offering", a term which could be argued to differ in scope from the present rule.

[10] FINRA Rule 5121(f)(6) defines "control" as:

(i) beneficial ownership of 10 percent or more of the outstanding common equity of an entity, including any right to receive such securities within 60 days of the member's participation in the public offering;
(ii) the right to 10 percent or more of the distributable profits or losses of an entity that is a partnership, including any right to receive an interest in such distributable profits or losses within 60 days of the member's participation in the public offering;
(iii) beneficial ownership of 10 percent or more of the outstanding subordinated debt of an entity, including any right to receive such subordinated debt within 60 days of the member's participation in the public offering;
(iv) beneficial ownership of 10 percent or more of the outstanding preferred equity of an entity, including any right to receive such preferred equity within 60 days of the member's participation in the public offering; or
(v) the power to direct or cause the direction of the management or policies of an entity.

## Conclusion

The proposed amendments, if adopted, leave important questions open. For instance, the proposed amendments vastly broaden Rule 5122 without describing in detail the reasons for the expansion. In particular, the expansion of the Rule by FINRA will in some cases create additional burdens on, and delays to, capital formation by small issuers that are engaged in private placements. These placements are already subject regulation by the SEC and by all 50 States, and, in the case of offerings conducted in accordance with Regulation D, to surveillance and public disclosure through the electronic filing of Form D with the Securities and Exchange Commission and with each State in which the offering is conducted. The proposed rule change also creates uncertainty for broker-dealers and for issuers as to whether the submission of offering documents in accordance with Rule 5122 will give rise to regulatory inquiry into the private placement. In this regard, FINRA notes that "if FINRA staff determines that an offering document presents an apparent investor protection issue, the responsible member should expect FINRA staff to contact the broker-dealer concerning the matter, whether or not the offering has already commenced."

The proposed amendments to Rule 5122 signal increased interest by FINRA into private placements. This interest was similarly signaled by FINRA Regulatory Notice 10-22, which describes the diligence required of FINRA members engaged in private placements. [11]

[11] If you wish to review a complete description of FINRA Regulatory Notice 10-22, you may refer to "FINRA Guidance: Member Firms' Responsibilities in Regulation D Offerings" (June 3, 2010), available at http://www.shearman.com/finra-guidance-member-firms-responsibilities-in-regulation-d-offerings-06-03-2010/.



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