

March 14, 2011
Via PDF email: 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:

This comment letter does not state or reflect the position of the Investment Program Association (“**IPA**”)¹ nor all of its members concerning FINRA’s proposal to amend FINRA Rule 5122 as more particularly set forth in Regulatory Notice 11-04 (“**NTM 11-04**” or “**Proposal**”). In submitting this letter, the IPA is merely facilitating an organized presentation to FINRA of comments received by the IPA from certain, but not all, of its members. Accordingly, it is on that basis alone that the IPA respectfully submits the following.²

The Proposal.

Subject to the retention of certain exemptions under FINRA Rule 5122³, the amendments proposed in the Notice would: (i) expand FINRA Rule 5122 to reach *all* private placements in which a FINRA member firm “participates” (not just those in which the member firm or its control entity is the issuer), and (ii) eliminate the exemption [FINRA Rule 5122(c)(4)] for offerings in which a member acts primarily in a wholesaling capacity. The foundational premise for the Notice is “[t]o provide investors with additional protection from fraud and abuse...[.]” See, *Proposal – Background and Discussion*, pg. 3.

¹ The IPA was formed in 1985 to provide the direct investment industry with effective national leadership, and today is the leading advocate for the inclusion of direct investments in a diversified investment portfolio. IPA members include direct investment product sponsors, FINRA member broker-dealer firms, and direct investment service providers. More information about the IPA is available at our website: <http://www.ipa.com>.

² While some commentators may raise concerns regarding FINRA’s statutory authority in connection with certain aspects of NTM 11-04, the IPA respectfully declines to do so in this comment letter.

Somewhat unrelated, but also expressed by certain of our members in reviewing the Proposal, are the concerns of IRA custodian and clearing broker dealers related to business activities tied to private placements not overtly called out in the Proposal. What the Proposal does not address are more specific standards a firm should consider when the firm facilitates unsolicited purchase and custody requests (i.e., when an IRA custodian or clearing broker dealer permits a customer to purchase an “unsolicited” private placement with money from their Qualified or Non-Qualified Brokerage Account). Although some comfort can be found in strict compliance with NTM 10-22, certain members expressed a desire for more clarity concerning what standards should firms consider with regard to transferring in and providing custody for these investments given the fact that they too are keen on investor protections and anti-fraud measures.

³ Under the Proposal, there is no exemption for offers and sales *solely* to accredited investors, as defined in Rule 501(a) of Regulation D. In fact, in connection with the original adoption of FINRA Rule 5122, FINRA specifically rejected an exemption based on offerings *solely* to accredited investors (See, *SEC File No. SR-2008-020*). Under existing law, certain non-accredited investors may invest in a Regulation D private placement of securities (with respect to which the Securities and Exchange Commission has already imposed extensive disclosure requirements – See, *Rule 502(b) promulgated under the Securities Act of 1933, as amended*). If the Proposal is adopted, perhaps as to offerings in which **only** accredited investors are participants, the “85/15” requirement could be made inapplicable.

Executive Summary.

As a fundamental principle, many view the foundational premise upon which the Proposal is based as being a natural progression following FINRA Regulatory Notice 10-22 similarly directed at the private placement industry in America. Unquestionably, the IPA recognizes *and* supports the importance of:

- investor protection, and
- the need for the industry as a whole to respond to recent abuses by broker-dealers in the sale of private placements.

However, many advance the proposition that the Proposal should instead be “disclosure” driven and not a “one size fits all – 85/15” mandate across all asset classes of private placement offerings implicated by the Proposal. Additionally, many have concerns regarding the potential chilling effect to small business capital formation in America in connection with the “**filing**” attributes of the Proposal. Lastly, we have passed on commentary for consideration on the topic of **fraud prevention** in the private placement space.

The IPA and FINRA have enjoyed a long standing cooperative and professional relationship, and it is in respect and furtherance of that history that we have assembled this commentary from certain of our membership on NTM 11-04.

Use of proceeds in a private offering in which a member “participates”⁴ – the 85/15 formula.

The Proposal would limit the percentage of offering proceeds that an issuer could apply to offering and organizational expenses for an unregistered offering of its securities, if (but only if) a FINRA member participates in that offering.

Congress purposely chose *not* to impose substantive or merit standards on securities offerings, whether registered or unregistered, seeking instead to rely on a disclosure approach.⁵ The fundamental purpose of the federal securities laws is to rely on a “philosophy of full disclosure” and “thus to achieve a high standard of business ethics in the securities industry.”⁶

Certain of IPA’s members have observed⁷ that the driver for the Proposal should not be a “one size fits all, 85/15” formulaic directive, but instead a detailed disclosure-based directive. More fundamentally, the

⁴ Under the Proposal, the term “participation” would be defined in FINRA Rule 5110(a)(5). Currently, FINRA Rule 5122 applies *only* if a member or an associated person “*offers or sells*” any securities in a member private offering. However, the term “participation”, as defined in FINRA Rule 5122(a)(5) is broader than merely engaging in the “offer or sale” of securities, and includes, any member or associated person providing “advisory or consulting” services to an issuer or who is involved in the preparation of the private placement memorandum, but who is not necessarily involved in the “offer or sale” of the securities of such private placement. Perhaps the foregoing should be the subject of re-evaluation.

⁵ See, 1 Louis Loss, Joel Seligman & Troy Paredes, Securities Regulation at 261 - 268 (4th ed. 2006).

⁶ See, *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

⁷ We note that in recent FINRA Rule 5122 amendments (Exchange Act Release No. 34-59262, related to SR-FINRA-2008-20 concerning Member Private Offerings), the IPA, and others, urged the non-imposition of a “one size fits all” formulaic approach to offering expenses. See, *IPA Comment Letter dated February 17, 2009 to Ms. Murphy*; See also, *Letter from Dexter M. Johnson for Mallon & Johnson, P.C. dated July 19, 2007*; *Letter from Peter J. Chepucavage for the International Association of Small Broker-Dealers and Advisors dated July 20, 2007*; *Letter from Mary Kuan for Securities Industry and Financial Markets Association dated July 27, 2007*; and *Letter from Keith F. Higgins for the American Bar Association Committee on Federal Regulation of Securities dated July 20, 2007*.

driver should be the full disclosure of “every penny in and every penny out, for what and to whom.” This disclosure-based approach is not without precedent in US federal securities law.⁸

The 85/15 directive would establish the proposition that: no investor, no matter how wealthy or how sophisticated could ever purchase, through a FINRA member firm and associated professional, any private placement product if the fully disclosed use of proceeds resulted in a 84.9 / 15.1 ratio. In an effort to underscore the fact that the driver should be robust disclosure, not a formulaic dictate, and at the risk of being “too cute,” the Proposal would prohibit America’s most wealthy from purchasing a \$50,000.00 unit in such an offering.

In limiting aggregate offering and selling costs to a *percentage* of the total offering proceeds, the Proposal would have a disproportionate effect on smaller private offerings, creating an unlevel playing field between smaller and larger private offerings, resulting in an anti-competitive effect on smaller private offerings. While it may be conventional to express selling compensation as a percentage of offering proceeds, many of the other offering expenses that would be subject to the limit under the Proposal are not so calculated, and cannot be limited to a fixed percentage of the offering amount. For example, the legal fees involved in preparing offering documents and related materials generally are not calculated with reference to the anticipated offering amount, and will necessarily represent a greater percentage of the proceeds raised for a smaller offering than for a larger offering. Other organizational fees also may be determined by factors unrelated to the offering amount and be subject to inherent minimum amounts. Certain offerings are not designed to produce ongoing cash flow that could cover offering, organizational, acquisition and other operational costs. The Proposal’s fixed percentage limits could hinder the ability of an issuer of a private offering (particularly the issuer of a smaller private offering) to raise capital through member firms – the recognized experts in capital raising.⁹ Of greater concern, the Proposal could force those issuers to explore alternative means of raising capital *without* the assistance of member firms. Such a result would surely be anathema to the industry. Certain of our members recommend FINRA’s consideration of the possibility of an adverse reaction to this aspect of the Proposal by the private placement sponsor community. Conceivably, a significant component of this sector may discontinue use of the professional services of licensed, experienced, knowledgeable FINRA member firms and professionals due to such constraints and instead sell private placement securities through unregulated “finders” and/or involving “issuer direct” sales *sans* FINRA member participation. By this one initiative,

⁸ For example, in the public context, Regulation SK provides for the disclosure approach.

⁹ In 1992, FINRA (then the NASD) published results of an analysis of an array of registered offerings illustrating the wide range of permissible underwriting compensation, taking into account the gross dollar amount of the offering and the offering type (*i.e.*, initial firm commitment offering, firm commitment secondary offering, and best efforts offering). See, Underwriting Compensation Received by Members in Public Corporate Equity Offerings, NASD Notice to Members 92-53; See also, NASD Notice to Members 83-15. These results showed underwriting compensation in excess of 15% in the case of a small, firm commitment offerings, notably, without regard to other offering costs, and as low as 5%. In explaining the range, the NASD observed that:

... a firm commitment initial public offering (IPO) is generally permitted higher compensation than a firm commitment secondary offering because the underwriter is dealing with an unseasoned issuer and is likely to incur higher costs in introducing the issuer to prospective underwriters and investors. The higher percentage levels of compensation permitted in smaller offerings recognizes that certain fixed costs are involved in any distribution, regardless of size.

See, NASD Notice to Members 92-53.

the industry could be pushed “underground” and become essentially unregulated. Such a result is not what FINRA intends and would serve a contra purpose to the foundational premise upon which the Proposal is based – investor protection – and a detriment to capital formation in America.

Lastly, we have received comments from certain of our membership that the Securities Act of 1934 (“**1934 Act**”) limits FINRA’s ability to promulgate rules that would impose a burden on competition. *See*, Section 15(A)(b)(6). They contend that the burden that would be imposed on competition by the Proposal is neither necessary nor appropriate in furtherance of the purposes of the 1934 Act.

The Filing Requirement.¹⁰

The Proposal’s filing requirement presents issues, only some of which are described below.

It has been suggested by certain of our members that FINRA give further consideration to its position that the filing rule, as proposed, “would not impose any delay in the offering.” There is a belief among certain of our members that there will be a real (and practical) chilling effect in the market (and among FINRA member firms) due to the lack of a “no-objections” letter (or similar clearance) or the lack of a set period of time within which FINRA would be obligated to submit its comments / position that “... an offering document presents an apparent investor protection issue...” in response to which position “... the responsible member should expect FINRA staff to contact the broker-dealer concerning the matter, whether or not the offering has already commenced.”

As currently drafted, they believe it will not be feasible to commence a private placement involving a FINRA member firm until FINRA has “completed its review,” and as currently drafted, there appears to be no objective benchmarks attendant to either a “no-objections” or “time limit” approach.¹¹ Additionally, it is likely that the number (if any) of member firms willing to undertake a private placement offering for a start-up, venture-backed, micro and small-cap company will be even more dramatically chilled. The potential liability concerns (to FINRA member firms, their associated professionals, and sponsors) from FINRA’s *ex post* review would prove to be untenable in the market. For example, all participants (member firm, sponsor, etc.) could be in distribution (e.g., with some investors having been admitted to the fund) or the fund may be fully subscribed, invested and closed. If FINRA were to thereafter release its determination that the “... offering document presents an apparent investor protection issue...” what should the member firm and sponsor do? – offer recession rights to those who invested, which could be the entire group of investors in the closed fund, - face FINRA’s determination serving as “Exhibit A” against the member firm in subsequent arbitration or litigation proceedings, whether or not related to the issue FINRA believed was an “apparent” investor protection issue?

¹⁰ See, NTM 11-04 – Background and Discussion, pg. 3 (concerning the *ex post* review proposal), and NTM 11-04 - Filing with FINRA, pg. 4.

¹¹ Given FINRA’s current workload associated with reviewing public offerings that are required to be filed under FINRA Rule 5110, we are not insensitive to the required devotion of additional resources to the substantially expanded application of the Proposal.

As an alternative to a “no-objections” approach, FINRA could establish a period of time (within 10 calendar days of filing) after which FINRA could not make additional inquiries.¹² By establishing such a specific period of time for FINRA inquiry, the process would avail FINRA of an opportunity to review filings, but still provide the requisite certainty to participants (member firms, investors and sponsors) conducting the offering as to when they could proceed without risk of receiving FINRA comments.¹³

In connection with the 120-day SEC review period originally proposed under the Senate version of what became the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“**Dodd-Frank Act**”), Senator Dodd proposed (a former Section 926, not that which ultimately became Section 926) the filing of offering materials with the SEC and provided a 120-day period for the SEC to review. If the SEC failed to take action on the materials filed during that period, the federal exemption (pre-emption) was lost and the program offering was then subject to regulation by the various States. At that time, there was an industry groundswell of opposition to the proposal based, in part, upon these same concerns – the chilling effect upon the market due to what essentially was a 120-day “stand down” period, the chill upon member firms who were unwilling to undertake marketing efforts for an offering with respect to which regulatory commentary could be forthcoming, and the resulting impairment of small business capital formation in America. The 120-day period was promptly abandoned by the Committee upon reporting the bill to the Senate floor. Therefore, long periods of “no news” from regulatory authorities (and in the Proposal, not even any time frame at all within which the industry can expect a response, if one “might” be forthcoming) have previously been untenable to the market.

Lastly, in connection with the Proposal’s filing requirement, it is reasonably anticipated that there will be a number of programs that will assemble a “selling group” of FINRA member firms to market and sell the securities described in the offering document. In such cases, we have received the suggestion, which we pass on to FINRA via this letter, recommending that only the Managing Broker Dealer (“**MBD**”) be required to file the offering document with FINRA, and then be required to certify, in writing, to the selling group member firms that such filing has taken place, with the certification being maintained among the books and records of the selling group member firms and auditable by FINRA and otherwise. To do otherwise, would result in unnecessary, duplicate filings by member firms of the same offering document. Absent the involvement of a MBD, then each of the member firms would be required to file the offering document with FINRA.

Fraud Prevention.

As stated previously, there is support for anti-fraud and abuse prevention measures (*See, Proposal – Background and Discussion, page 4*) benchmarked upon a disclosure-based approach, not formulaic restrictions applied across all offering types and all asset groups.

The question remains, precisely what is the Proposal endeavoring to capture or achieve that is not already present, under existing law, with respect to fraud and abuse. FINRA’s recent NTM 10-22, which applied

¹² FINRA may be contemplating the use of enhanced computer capabilities to optically scan or otherwise search filed offering materials (PPMs) in an effort to enhance identification of problematic areas and concerns. If implemented, a reasonable window of time for such review would be achievable, such as the 10 calendar day period.

¹³ In the event disclosure issues are discovered more than 10 calendar days after filing with FINRA, remedies under state and federal securities laws, including Rule 10b-5 under the 1934 Act would still be available.

industry-wide substantially advances investor protections. Section 926 of the Dodd-Frank Act will take significant strides to enhance investor protections against fraud and abuse by fashioning “bad actor” disqualifications as a part of federal law. Additionally, the SEC and the States continue to retain a full complement of laws aimed at fraudulent conduct at their disposal.

Accordingly, given prior, clear and unambiguous Congressional enactments regarding disclosures to accredited investors in private placement offerings when taken in the context of NTM 10-22, recent Dodd-Frank “bad actor” provisions, and that which has been retained by the SEC and the States, certain of our members believe that the Proposal’s disclosure requirements, together with its filing requirements, coupled with a non-formulaic approach to the use of offering proceeds, all as commented upon herein, should be sufficient to achieve FINRA’s articulated desire and intention to provide “additional protection from fraud and abuse.”

Respectfully submitted.



Jack L. Hollander
Chairman, Investment Program Association