Regulatory Notice 11-04

Private Placements of Securities

FINRA Requests Comment on Proposed Amendments to FINRA Rule 5122 to Address Member Firm Participation in Private Placements

Comment Period Expires: March 14, 2011

Executive Summary

FINRA requests comment on a proposal to amend FINRA Rule 5122, which requires, subject to certain exemptions, disclosure in the offering document of the intended use of offering proceeds, expenses, and the amount of selling compensation to be paid to the broker-dealer and its associated persons, in any private placement in which a participating broker-dealer (or its control entity) is the issuer.[1] The rule also requires that at least 85 percent of the offering proceeds must be used for the business purposes identified in the offering document. Lastly, the rule requires each offering document to be submitted to FINRA to allow the staff to conduct *ex post* reviews to assess compliance with the rule and to identify problematic terms and conditions.

The amendments proposed in this *Notice* expand Rule 5122 to reach all private placements in which a member firm participates—not just those in which the member firm (or its control entity) is the issuer—while retaining nearly all of the existing exemptions, including those for offerings sold solely to certain institutions, qualified purchasers and other sophisticated investors. However, to reflect the broader scope of the proposed rule and its prior experience with Rule 5122, FINRA proposes to eliminate the exemption for offerings in which a member acts primarily in a wholesaling capacity.

The text of the proposed rules is available as Attachment A to this *Notice*.

Questions regarding this *Notice* should be directed to:

- Joseph E. Price, Senior Vice President, Corporate Financing/Advertising Regulation, at (240) 386-4623; or
- Gary L. Goldsholle, Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8104.

January 2011

Notice Type
- Request for Comment

Suggested Routing
- Compliance
- Corporate Financing
- Executive Representative
- Legal
- Operations
- Senior Management

Key Topics
- Affiliates
- Institutional Accounts
- Member Private Offerings
- Offering Proceeds
- Private Placements
- Private Placement Memoranda
- Regulation D

Referenced Rules & Notices
- FINRA Rule 2010
- FINRA Rule 2020
- FINRA Rule 2111
- FINRA Rule 5122
- FINRA Rule 5110
- NASD Rule 2210
- NASD Rule 3010
- NTMs 03-71, 05-18 and 05-48
- Regulation D
- Regulatory Notices 09-05 and 09-27
- SEA Section 10(b)
- SEA Rule 10b-5
- Securities Act Section 17

FINRA
Financial Industry Regulatory Authority

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by March 14, 2011.

Member firms and other interested parties can submit their comments using the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

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

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. Generally, FINRA will post comments on its site one week after the end of the comment period.[2]

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.[3]

Background and Discussion

FINRA Rule 5122 was developed in response to abuses in the sale of private placements issued by broker-dealers and their control entities.[4] Rule 5122 generally requires, subject to certain exemptions, that a member firm or associated person engaging in a private placement of unregistered securities issued by the firm (or a control entity of the firm):

- disclose to investors in a private placement memorandum, term sheet or other offering document the intended use of offering proceeds, the offering expenses and the amount of compensation that will be paid to the broker-dealer and its associated persons;
- submit, via email, the offering document to the FINRA Corporate Financing Department at or prior to the time it is provided to any prospective investor; and
- comply with the requirement that at least 85 percent of the offering proceeds raised may not be used to pay for offering costs, discounts, commissions or any other cash or non-cash sales incentives, and must be used for the business purposes disclosed in the offering document.[5]

FINRA staff conducts *ex post* reviews of offering documents to assess compliance with the rule and to identify problematic terms and conditions. Occasionally, when warranted, FINRA will contact a member firm and request additional information regarding the use of proceeds or other clarifying information. The rule does not require that completion of an offering be delayed until FINRA staff has issued a "no-objections" letter, as FINRA Rule 5110 requires with respect to public offerings.

Rule 5122 defines "control" as beneficial interest 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 non-corporate entity. The rule also provides various exemptions, including offerings of private placements:

- to institutional accounts, qualified purchasers, qualified institutional buyers, investment companies and banks;
- to employees of the issuer (or its control entity) and securities issued in certain conversions, stock splits and restructuring transactions;
- of exempted securities, certain notes with short-term maturities, variable contracts, modified guaranteed annuity contracts and life insurance policies, commodity pools, options and other derivatives not based principally on the member's (or its control entity's) securities, unregistered investment grade rated debt and preferred securities; and
- in which the member acts primarily in a wholesaling capacity, as evidenced by an agreement to sell less than 20 percent of the offered securities in retail transactions.

Rule 5122 plays an important part in the effort to protect investors in the narrow segment of the private placement market it was designed to address. It does not, however, address private placements in which the issuer is neither a broker-dealer nor its control entity.[6] The vast majority of private placements remain outside the scope of the rule. As an illustration, FINRA has received approximately 300 filings pursuant to Rule 5122 during the first year that the rule has been in effect, whereas several thousand Form Ds are filed annually with the SEC in connection with private placements.[7]

To provide investors with additional protection from fraud and abuse, FINRA proposes to amend Rule 5122 to govern all private placements in which a member participates, subject to certain exemptions.

Proposed Rule Changes

As described below, FINRA proposes to expand the rule to reach any private placement in which a member participates, subject to all but one of the exemptions that exist in the rule today.

Participation in a Private Placement

The proposed amendments incorporate the definition of "participation" from Rule 5110 (Corporate Financing Rule), which corresponds to the types of services typically provided by a broker-dealer in a private placement.[8] Because designation as a "control entity" would no longer be relevant to the scope of the rule, the proposed amendments delete that term.

Disclosure Requirements

Given the expanded scope of the amended rule, FINRA proposes that member firms participating in a private placement of securities issued by an affiliate alert investors to potential conflicts of interest. Specifically, the proposed amendments require that the offering document disclose if a participating member is an affiliate of the issuer and the nature of the affiliation.[9] In several recent SEC and FINRA enforcement cases concerning private placements, a participating broker-dealer was affiliated with the issuer, and this affiliation facilitated the broker-dealer's misuse or conversion of offering proceeds.[10]

To ensure that the disclosure requirements reach the amount and type of *any* compensation that will be paid directly or indirectly to a participating member firm for its associated persons in connection with a private placement subject to the rule, the proposed amendments replace the term "selling compensation" with the term "compensation."[11]

Filing With FINRA

Under the proposed amendments, as under the current rule, an offering document for any private placement subject to the rule would have to be filed with FINRA at or prior to the first time it is provided to any prospective investor. As under the current rule, the filing requirement would not impose any delay in the offering. The offering may proceed while FINRA staff reviews the offering document. Of course, 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.

Use of Offering Proceeds

Under the proposed amendments, as under the current rule, at least 85 percent of the offering proceeds of a private placement subject to the rule may not be used to pay for offering costs and compensation, and must be used for business purposes disclosed in the offering document. Neither the current rule nor the proposed amendments place any limitation on the amount that may be paid for offering costs and compensation. They merely restrict the *percentage of offering proceeds* that may be used for those purposes. This provision has had the salutary effect of ensuring that the offering document discloses the business purposes of the offering, that investors' money is dedicated to those business purposes, and that no more than 15 percent of the money raised is used to pay for offering costs and compensation. For that reason, we propose to preserve this provision in the expanded rule.

In addition, to conform to proposed changes in the section on disclosures discussed above,[12] the proposed amendments replace the phrase "any other cash or non-cash sales incentives" with the phrase "any other compensation to participating broker-dealers or associated persons."

Elimination of Wholesaling Exemption

The proposed amendments eliminate the existing exemption under Rule 5122(c) for offerings in which a member acts primarily in a wholesaling capacity. The basis for this exemption was that distribution of the private placement by independent retail broker-dealers would obviate the need for the rule, which focused on private placements in which the selling member or its control entity was the issuer. However, recent enforcement cases have involved private placements in which a broker-dealer affiliated with an issuer acted primarily as the wholesaler, thus demonstrating the need for more investor protection.[13] Moreover, 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.

Request for Comment

FINRA specifically requests comment on certain aspects of the proposed amendments. Are any other modifications to the requirements concerning use of proceeds, disclosure and filing, other than those proposed, necessary or appropriate to afford protection to investors, in light of the proposed expansion of the rule? Are there any additional investor protections that the rule should provide? Do the exemptions in the proposed rule continue to ensure that the types of private placements that generally have not presented investor protection concerns will be excluded from the rule?

Based on FINRA's experience with the current rule, it does not appear that the filing requirement has been unnecessarily burdensome to firms. As discussed above, the filing requirement does not require any delay in the offering while FINRA staff reviews the filing. Nevertheless, are there any improvements in the filing process that could ensure that firms are not subject to unnecessary burdens? Are there any approaches that could further improve the efficiency of the filing process?

We also request comment on the existing requirement that at least 85 percent of the offering proceeds of a private placement subject to the rule may not be used to pay for offering costs and compensation and must be used for the business purposes disclosed in the offering document. Neither the current rule nor the proposed amendments place any limitation on the amount that may be paid for offering costs and compensation. They merely restrict the *percentage of offering proceeds* that may be used for those purposes. Nevertheless, we request comment on whether this requirement imposes an unnecessary burden on smaller private placements. If so, please provide specific examples of these burdens.

Endnotes

1 The term "private placement" refers to a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act of 1933.

2 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.

3 Section 19 of the Securities Exchange Act of 1934 (SEA or Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing.

4 *See e.g., SEC v. Provident Royalties, LLC.*, SEC Complaint No. 3-09-cv-1238-L (filed July 1, 2009), Litigation Release No. 21118 (July 7, 2009) and related FINRA case *Dep't of Enforcement v. Provident Asset Management, LLC, AWC* No. 2009017497201 (March 17, 2010) (private placements sold to thousands of investors using offering documents that contained material omissions regarding the use of offering proceeds). *In re David V. Siegel*, Rel. 34-62803 (August 31, 2010) and *In re Axiom Capital Management*, Exchange Act Release No.61563 (February 22, 2010) (SEC found Siegel and Axiom failed to supervise unsuitable sales of private placements made by registered representatives to customers who were elderly, retired with limited income and risk averse); *In re Mark Tuminello*, Exchange Act Release No. 59739 (April 9, 2009) (SEC found that Tuminello failed to disclose material information and concealed facts that made models incorporated into the private placement offering documents misleading); *In re Ross Owen Haugen*, Exchange Act Release No.59458 (February 26, 2009) (SEC found that Haugen sold $15 million in private placement securities and made false representations that contradicted statements in the private placement memorandum); *In re Jeffrey L. Gibson*, (SEC Opinion) Exchange Act Release No. 57266 (February 4, 2008) (SEC found that Gibson raised $875,000 in connection with the offer and sale of a private placement and then misappropriated $450,000 to purchase commercial real property); *In re Maria T. Giesige*, (SEC Opinion) Exchange Act Release No. 60000 (May 29, 2009) (SEC found that Giesige raised $1.49 million in a private placement that resembled a Ponzi scheme and failed to perform due diligence on the issuer prior to recommending that clients invest in the offering). *See also, Dep't of Enforcement v. Pinnacle Partners Financial Corporation*, Complaint No. 2010021324501 (Press Rel. December 3, 2010); *SEC v. Medical Capital Holdings, Inc.*, Litigation Release No. 21141 (July 20, 2009).

5 Rule 5122 became effective on June 17, 2009.

6 FINRA has issued guidance concerning a broker-dealer's responsibilities with respect to private placements. In April 2010, FINRA published *Regulatory Notice 10-22*, which reminds broker-dealers of their regulatory obligations under FINRA's suitability rule and the anti-fraud requirements of the federal securities laws to conduct a reasonable investigation of the issuer and securities they recommend in private placements.

Endnotes continued

7 *See* Report of U.S. Securities and Exchange Commission, Office of Inspector General, Office of Audits (March 31, 2009), which noted that in 2008 there were over 20,000 Form D filings that represented total estimated offerings of $609 billion. FINRA staff's review of a sample of filings made in 2010 indicates that approximately 15 percent disclosed broker-dealer participation in a particular offering.

8 Rule 5110(a)(5) defines "participation" as the following:

> 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 SEC Rule 13e-3.

9 An "affiliate" would be defined as a company that controls, is controlled by or is under common control with a broker-dealer.

10 *See e.g., Provident, supra* note 4, in which the controlling broker-dealer told investors that 86 percent of the offering proceeds would be allocated to oil and gas investments when in fact more than 50 percent of the proceeds were used to pay the dividends and expenses of earlier offerings.

11 The term "selling" was improperly viewed by some as narrowing the disclosure requirements beyond those which were intended by the rule.

12 *See supra* note 11.

13 *See e.g., Provident, supra* note 4; *SEC v. Sunwest Management Inc.*, Case No. CV-06056-TC, Litigation Release No. 20920 (March 2, 2009); and *State of Idaho v. Douglas Swenson, DBSI, Inc., et al.*, Complaint No. cv0C0900859 (January 14, 2009). The SEC alleged that Sunwest and its affiliated broker-dealer that acted as the wholesaler in a private placement that raised over $300 million from more than 1,300 investors made false promises of high annual returns while concealing that proceeds from new investors were commingled to pay other investors. The State of Idaho alleged that DBSI Securities, a wholesaler affiliated with the issuer, raised over $1 billion while defrauding investors, commingling funds and omitting material information. In each of these cases, independent broker-dealers sold the issuers' securities to retail investors.

ATTACHMENT A

The following is the text of the proposed amendments to Rule 5122. New text is underlined; deletions are in brackets.

5122. Private Placements of Securities [Issued by Members]

(a) Definitions

[(1) Member Private Offering]

[A "member private offering" means a private placement of unregistered securities issued by a member or a control entity.]

[(2) Control Entity]

[A "control entity" means any entity that controls or is under common control with a member, or that is controlled by a member or its associated persons.]

[(3) Control]

[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.]

(1) Affiliate

The term "affiliate" means a company that controls, is controlled by or is under common control with a broker-dealer.

(2) Control

For purposes of this Rule, the term "control" has the meaning specified in Rule 5121.

(3) Participation

For purposes of this Rule, the term "participation" has the meaning specified in Rule 5110(a)(5).

(4) Private Placement

The term "private placement" means a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act.

(b) Requirements

No member or associated person may [offer or sell any security] participate in a [Member Private Offering] private placement unless the following conditions have been met:

(1) Disclosure Requirements

(A) If an offering has a private placement memorandum or term sheet, then such memorandum or term sheet must be provided to each prospective investor and must contain the following disclosures [addressing]:

(i) the intended use of the offering proceeds; [and]

(ii) the offering expenses and the amount and type of [selling] compensation that will be paid to [the member] participating broker-dealers [and its] or associated persons; and

(iii) if applicable, that the issuer and any participating broker-dealer are affiliates and the nature of the affiliation.

(B) If an offering does not have a private placement memorandum or term sheet, then the member must prepare an offering document that contains the disclosures required in subparagraph (b)(1)(A) [(i) and (ii)] and provide such document to each prospective investor.

(2) Filing Requirements

[A member must file t] The private placement memorandum, term sheet or such other offering document must be filed with the Corporate Financing Department at or prior to the first time the document is provided to any prospective investor. Any amendment[(s)] or exhibit[(s)] to the private placement memorandum, term sheet or other offering document also must be filed with the Department within ten days of being provided to any investor or prospective investor.

(3) Use of Offering Proceeds

For each [Member Private Offering] private placement, at least 85% of the offering proceeds raised [must] may not be used [for business purposes, which shall not include] to pay for offering costs, discounts, commissions, [or any other cash or non-cash 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)]

(4) Correction of Errors

If, in connection with [the offer and sale of] any private placement [security in a Member Private Offering], a member or associated person discovers after the fact that one or more of the conditions [listed above] of this Rule have not been met, the member or associated person must promptly conform the offering to comply with this Rule.

(c) Exemptions

The following [Member Private Offerings] private placements are exempt from the requirements of this Rule:

(1) offerings sold solely to:

(A) institutional accounts, as defined in NASD Rule 3110(c)(4);

(B) qualified purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act;

(C) qualified institutional buyers, as defined in Securities Act Rule 144A;

(D) investment companies, as defined in Section 3 of the Investment Company Act;

(E) an entity composed exclusively of qualified institutional buyers, as defined in Securities Act Rule 144A; and

(F) banks, as defined in Section 3(a)(2) of the Securities Act.

(2) offerings of exempted securities, as defined in Section 3(a)(12) of the Exchange Act;

(3) offerings made pursuant to Securities Act Rule 144A or SEC Regulation S;

[(4) 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);]

[(5)](4) offerings of exempt securities with short term maturities under Section 3(a)(3) of the Securities Act;

[(6)](5) offerings of subordinated loans under SEA Rule 15c3-1, Appendix D (see NASD Notice to Members 02-32 (June 2002));

[(7)](6) offerings of "variable contracts", as defined in Rule 2320(b);

[(8)](7) offerings of modified guaranteed annuity contracts and modified guaranteed life insurance policies, as referenced in Rule 5110(b)(8)(E);

[(9)](8) offerings of unregistered investment grade rated debt and preferred securities;

[(10)](9) offerings to employees and affiliates of the issuer or its control entities;

[(11)](10) 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;

[(12)](11) offerings of securities of a commodity pool operated by a commodity pool operator, as defined under Section 1a(5) of the Commodity Exchange Act;

[(13)](12) offerings of equity and credit derivatives, including OTC options; provided that the derivative is not based principally on the member or any if its control entities; and

[(14)](13) offerings filed with the Department under Rules 2310, 5110 or Rule 5121.

(d) Confidential Treatment

FINRA shall accord confidential treatment to all documents and information filed pursuant to this Rule and shall utilize such documents and information solely for the purpose of review to determine compliance with the provisions of applicable FINRA rules or for other regulatory purposes deemed appropriate by FINRA.

(e) Application for Exemption

Pursuant to the Rule 9600 Series, FINRA may exempt a member or associated person from the provisions of this Rule for good cause shown.