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FINRA Proposes New Rule 5122 To Govern Member Private Offerings

The Financial Industry Regulatory Authority, Inc. ("**FINRA,**" formerly known as the "**NASD**") filed with the U.S. Securities Exchange Commission ("**SEC**") on June 5, 2008 a proposed rule change to adopt new FINRA Rule 5122 (the "**Rule**"). If accepted, this Rule would require a member that engages in a private placement[1] of unregistered securities issued by members of their own securities or those of a control entity (as discussed below) ("**Member Private Offerings**") to: (i) make certain disclosures to investors in a private placement memorandum ("**PPM**"); (ii) file the PPM with FINRA; and (iii) commit that no less than eighty-five percent (85%) of the offering proceeds will be used for the business purposes identified in the PPM.[2] The proposed Rule also contains several exemptions, which are more fully set forth below, for offerings to certain types of institutional investors, offerings under various provisions of the federal securities laws for which FINRA believes the protections of the proposed Rule are not necessary, and offerings in which investors otherwise would be expected to have access to sufficient information about the issuer. Set forth below is a summary and analysis of FINRA's proposed Rule.

For the sake of clarity, a "control entity" means "a beneficial interest," as defined in FINRA Rule 2790(i)(1), of more than fifty percent (50%) of the outstanding voting securities of a corporation, or the right to more than fifty percent (50%) of the distributable profits or losses of a partnership or other non-corporate legal entity. However, the power to direct the management or policies of a corporation or partnership alone (*e.g.*, a general partner) – absent meeting the majority ownership or right to the majority of profits – would *not* constitute "control" as defined in the proposed Rule. *For example*, if broker-dealer ABC owns fifty percent (50%) of corporation DEF that in turn holds a sixty percent (60%) interest in corporation GHI, and ABC is engaged in a private offering of GHI, ABC would have a thirty percent (30%) interest in GHI (50% of 60%), and thus GHI would not be considered a control entity under this definition.[3]

Note that the proposed Rule, once implemented, will *not apply retroactively* to any offerings that have already commenced selling efforts.

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[1] A non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act of 1933, as amended.

[2] See SR-FINRA-2008-020 release, available at: http://www.finra.org/RulesRegulation/RuleFilings/2008RuleFilings/P038614.

[3] Id. Please also note that performance and management fees earned by a general partner would *not* be included in the determination of partnership profit or loss percentages; *provided, however,* that if such performance and management fees are subsequently re-invested in the partnership, thereby increasing the general partner's ownership interest, then such interests *would be* considered in determining whether the partnership is a control entity. See FINRA Notice To Members, 07-27.

Background and Intent behind Proposed Rule 5122

FINRA proposed Rule 5122 in response to problems it identified in connection with numerous Member Private Offerings. Over the course of the past several years, FINRA has investigated and brought many enforcement cases concerning abuses in connection with Member Private Offerings.[4] It was alleged in these cases, among other things, that members failed to provide PPMs to investors, or in such cases where PPMs were provided, they contained misleading, incorrect or selective disclosure, such as omissions and misrepresentations regarding such member's selling compensation and its use of offering proceeds. FINRA also surveyed member firms that had engaged in Member Private Offerings and found situations where a portion of the offering proceeds were used for individual bonuses, sales contest awards, commissions in excess of twenty percent (20%), or other undisclosed compensation.[5]

Based upon the foregoing investigations and surveys, FINRA proposed Rule 5122 in order to stem such abuses and to provide investor protections for Member Private Offerings that are similar to the protections provided by FINRA for public offerings.[6] As a general rule, FINRA reviews member participation in public offerings (subject to certain exceptions) in order to ensure that such members' underwriting compensation and expenses paid are fair, that the terms and arrangements are equitable, and that there exists no undisclosed conflicts of interest.[7]

Insofar as Member Private Offerings are private placements, however, they currently are *not* subject to existing FINRA rules governing underwriting compensation and conflicts of interest by members participating in public offerings. Therefore, the proposed Rule is intended to provide for a review of Member Private Offerings similar to that of public offerings by adding a layer of protection to Member Private Offering investors.[8]

What the Proposed Rule Requires

(1) Filing Requirements: The first substantive requirement under the proposed Rule is that any member involved in a Member Private Offering would be required to file a PPM with the Corporate Finance Department of FINRA at or prior to the first time it is provided to any prospective investor. In addition, any amendments or exhibits to the PPM also would be required to be filed by the member with the Corporate Finance Department within ten days of being provided to any prospective investor. The purpose of the filing requirement is to allow FINRA to identify those PPMs that are deficient "on their face." In its proposal, FINRA also stated that it intends to develop a Web-based system (likely similar to that of FINRA's existing COBRADesk Website) that would allow members to file their PPMs electronically.[9]

Of importance, pursuant to the proposed Rule, FINRA will *not* review the offering or require the issuance of a "no-objections" letter. Notably, this is unlike FINRA's existing Corporate Financing Rule 2710, which, barring an exemption therefrom, mandates review and approval by FINRA of a member's underwriting/placement compensation and arrangements in a public offering before such member may commence the offering. However, if FINRA subsequently determines that disclosures in the PPM appeared to be incomplete, inaccurate or misleading, FINRA could make further inquiries.

(2) Disclosure: The proposed Rule requires that a member provide a PPM to each prospective investor in a Member Private Offering, whether accredited or not, and that the PPM disclose (i) the intended use of the offering proceeds, (ii) the offering expenses and (iii) the selling compensation paid to the member. In its proposal, FINRA stated that it believes that every investor in a Member Private Offering should receive this basic information concerning the offering.

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4 See, e.g., Franklin Ross, Inc., FINRA No. E072004001501 (settled April 2006), summarized in FINRA Notice Disciplinary Actions, p. 1 (May 2006); Capital Growth Financial, LLC, FINRA No. E072003099001 (settled February 2006), summarized in FINRA Notice Disciplinary Actions, p. 1 (April 2006); Craig & Associates, FINRA No. E3B2003026801 (settled August 2005), summarized in FINRA Notice Disciplinary Actions, p. D6 (October 2005); Online Brokerage Services, Inc., FINRA No. C8A050021 (settled March 2005), summarized in FINRA Notice Disciplinary Actions, p. D5 (May 2005); IAR Securities/Legend Merchant Group, FINRA No. C10030058 (settled July 2004), summarized in FINRA Notice Disciplinary Actions, p. D1 (July 2004).

5 See SR-FINRA-2008-020 release, available at: http://www.finra.org/RulesRegulation/RuleFilings/2008RuleFilings/P038614.

6 FINRA regulates corporate financing transactions directly through a number of its rules, including the "Corporate Financing Rule," FINRA Rule 2710, and the "Conflict of Interest Rule," FINRA Rule 2720.

7 See FINRA Rules 2710, 2720 and 2810.

8 It is also important to note that Members would remain subject to other FINRA rules that govern a member's participation in the offer and sale of a security, including FINRA Rules 2110, 2120 and Rule 2310. Members also are subject to the anti-fraud provisions of the federal securities laws, including Sections 10(b), 11, 12 and 17 of the Securities and Exchange Act of 1934, as amended.

9 The proposed rule change also does not impose any additional requirements regarding filing of advertisements or sales materials, which would continue to be governed by FINRA Rule 2210.

(3) Use of Proceeds: The proposed Rule also would require that *each time* a *Member Private Offering is closed* no less than eighty-five percent (85%) of the gross offering proceeds raised in the Member Private Offering be used for the business purposes identified in the PPM. This requirement was created to address abuses in which members or control entities used substantial amounts of offering proceeds for selling compensation and related party benefits, rather than business purposes.[10]

Two Important Notes With Respect to Offering Proceeds:

(i) The proposed Rule does not impose a limit on the total amount of underwriting compensation that can be paid. Instead, pursuant to the proposed Rule, offering and other expenses may total more than 15% of the offering proceeds; *provided, however,* that no more than fifteen percent (15%) of the monies raised from investors in a particular Member Private Offering can be used to pay such expenses. This implies that, although unlikely, members may go out-of-pocket, in order to pay for offering expenses that exceed this 15% threshold; and

(ii) If a member plans to conduct a series of Member Private Offerings, the member should make certain that each Member Private Offering meets the above-noted 85% requirement, not just the series as a whole.

Confidential Treatment

In its proposal, FINRA also stated that it will accord "confidential treatment" to all documents and information filed with the Corporate Finance Department pursuant to the proposed Rule and will utilize such documents and information solely for the purpose of its review in order to determine compliance with applicable FINRA rules or for other regulatory purposes deemed appropriate by FINRA. Consistent with this provision, FINRA stated that it will set up a Website so that filers may submit to FINRA's Corporate Finance Department any required filing, such as the PPM, under the proposed Rule. This is similar to FINRA's current COBRADesk filer system, which facilitates the submission of information and documents to FINRA, and which requires a protected user ID and password to gain access to its system.

Rule Exemptions

Proposed Rule 5122 includes a number of exemptions for certain types of "offerings," as well as certain "categories of investors," such as sales to Qualified Institutional Buyers. These exemptions are based upon FINRA's investigative findings, which did not reveal abuses with regard to such offerings or purchasers, the latter of which are generally sophisticated, participate in numerous securities purchases, and are able to conduct appropriate due diligence prior to making an investment. The exemptions are as follows:

(1) Exempt Offerings:

- offerings of exempt securities, as defined by Section 3(a)(12) of Exchange Act of 1934, as amended (the "**Exchange Act**");
- offerings made pursuant to Securities Act Rule 144A of SEC Regulation S;
- 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);
- offerings of subordinated loans under SEC Rule 15c3-1, Appendix D;
- offerings of "variable contracts" as defined in FINRA Rule 2820;
- offerings of modified guaranteed annuity contracts and modified guaranteed life insurance policies, as referred to in FINRA Rule 2810(b)(8)(E);
- offerings of securities of a commodity pool operated by a commodity pool operator as defined under Section 1a(5) of the Commodity Exchange Act;
- offerings of equity and credit derivatives, including OTC options, provided that the derivative is not based principally on the member or any of its control entities; and
- offerings filed with FINRA under FINRA Rules 2710, 2720 or 2810.

[10] See SR-FINRA-2008-020 release, available at: http://www.finra.org/RulesRegulation/RuleFilings/2008RuleFilings/P038614.

(2) Exempt Investors (the proposed Rule would exempt Member Private Offerings sold solely to the following):

- 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 Securities Act Rule 144A);
- investment companies (as defined in Securities Act Rule 144A);
- an entity composed exclusively of qualified institutional buyers; and
- banks (as defined in Securities Act Rule 144A).

(3) In addition, the proposed Rule would exempt the following Member Private Offerings in which FINRA would expect investors not to require the protections of the proposed Rule:

- offerings of unregistered investment grade-rated debt and preferred securities;
- offerings to employees and affiliates of the issuer or its control entities; and
- offerings of securities issued in conversions, stock splits and restructuring transactions executed by an already existing investor without the need for additional consideration or investments on the part of the investor.

In its release, FINRA stated that is will publish a Regulatory Notice within sixty (60) days of the SEC's approval of the proposed Rule regarding the implementation date of the proposed Rule, which will be thirty (30) days following the publication of such Regulatory Notice.

Julie M. Allen
212.969.3155 – jallen@proskauer.com

Allan R. Williams
212.969.3220 – awilliams@proskauer.com

Stuart Bressman
212.969.3470 – sbressman@proskauer.com