



FINRA Proposes Amendments to FINRA Rule 5122 to Address Member Firm Participation in Private Placements

On January 11, 2011, the Financial Industry Regulatory Authority (“FINRA”) issued Regulatory Notice 11-04 (the “Notice”) proposing to expand FINRA Rule 5122 to govern 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 all but one of the existing exemptions, including those for offerings sold solely to certain institutions, qualified purchasers and other sophisticated investors.¹ If the amendments were adopted, a member broker-dealer would be required to file the offering document for any private placement in which the member participates, subject to certain exemptions.

Background

FINRA Rule 5122 was adopted in 2009 in response to abuses in the sale of private placements by member broker-dealers and their control entities. Currently, FINRA Rule 5122 applies *only* to private placements of securities *issued* by member broker-dealers and certain affiliated entities. However, the vast majority of private placements remain outside the scope of the rule. FINRA seeks to expand FINRA Rule 5122 to govern all private placements in which a member participates, subject to certain exemptions.

Proposed Amendments to FINRA Rule 5122

Participation in a Private Placement

The expanded rule would incorporate the broad definition of “participation” in FINRA Rule 5110, which corresponds to the types of services typically provided by a broker-dealer in a private placement. Rule 5110(a)(5) defines “participation” 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 SEC Rule 13e-3.”

¹ See FINRA 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” (January 2011), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122787.pdf>.

If the rule is amended, customary placement agent activities by a member broker-dealer in connection with private placements and PIPEs would generally fall under this definition and subject the broker-dealer to the requirements of FINRA Rule 5122 in connection with its participation.

Disclosure Requirements and Use of Proceeds Limitation

FINRA Rule 5122 currently requires disclosure in the offering document² of the use of proceeds, offering expenses and selling compensation to the member broker-dealer and its associated persons. The rule would continue to require that at least 85 percent of the proceeds (i) be used for the business purposes disclosed in the offering document, and (ii) not be used to pay offering costs, commissions or other compensation to participating broker-dealers and their associated persons. In the Notice, FINRA proposes to require additional disclosure if a participating broker-dealer is an affiliate of the issuer and the nature of the affiliation.³ In addition, in order to capture the amount and type of *any* compensation that will be paid directly or indirectly to a participating member broker-dealer, the proposed amendments replace the term “selling compensation” with the term “compensation.”

Filing with FINRA

FINRA Rule 5122 would continue to require each offering document to be submitted to FINRA at or prior to the first time it is provided to any prospective investor, in order to allow the FINRA staff to conduct *ex post* reviews. While the Notice states that the filing requirement would not impose any delay in the offering, and the offering may proceed while staff reviews the offering document, a broker-dealer may want to consider waiting for a confirmation from the FINRA staff before completing the offering, in order to avoid comments to the disclosure at a time when changes are impractical to make.⁴

Exemptions from FINRA Rule 5122

FINRA proposes to eliminate the existing exemption under FINRA Rule 5122(c) for offerings in which a member acts primarily in a wholesaling capacity, referring to recent enforcement cases involving private placements in which a broker-dealer affiliated with an issuer acted primarily as the wholesaler, as a demonstration of the need for more investor protection. 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.

FINRA Rule 5122 would otherwise continue to exempt offerings to institutional accounts, qualified purchasers, qualified institutional buyers (QIBs), investment companies, banks and employees and affiliates of the issuer, as well as offerings pursuant to Rule 144A and Regulation S, and offerings of specified types of securities, including commodity pool interests, unregistered investment grade rated debt and preferred securities.

FINRA requests comments to the proposed amendments by March 14, 2011.

FINRA's Focus on Abuses in the Private Placement Market

The proposed amendments to FINRA Rule 5122 would significantly expand FINRA's oversight of the private placement market. The Notice constitutes the most recent example in a trend illustrating FINRA's increased focus on the private placement market.⁵ FINRA issued Regulatory Notice 10-22 in April 2010 reminding broker-dealers of their regulatory obligations under FINRA's suitability rule and the anti-fraud requirements of the federal

² A private placement memorandum, term sheet or other offering document.

³ An “affiliate” would be defined as a company that controls, is controlled by or is under common control with a broker-dealer.

⁴ Note this is unlike FINRA Rule 5110, which requires that completion of an offering be delayed until FINRA staff has issued a “no-objections” letter with respect to public offerings.

⁵ See the Notice at footnote 4 citing examples of recent FINRA and SEC enforcement cases.

securities laws to conduct a reasonable investigation of the issuer and securities they recommend in private placements.⁶

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

⁶ See our Client Alert "FINRA Issues Regulatory Notice Reminding Broker-Dealers of their Obligation to Conduct Reasonable Investigations in Regulation D Offerings," available at <http://www.mof.com/files/Uploads/Images/100527FINRA.pdf>.