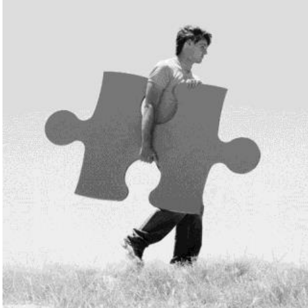
 February 12, 2016



FINRA Reminds Members of Obligations in Offerings Subject to a Contingency

On February 8, 2016, FINRA released Regulatory Notice 16-08 relating to the contingency offering requirements of Rules 10b-9 and 15c2-4 under the Exchange Act. The Notice arises from FINRA's review of various private placement offering documents in connection with FINRA Rule 5123's filing requirement for certain offerings. FINRA observed that broker-dealers have not always complied with the regulatory requirements applicable to contingency offerings. Accordingly, the Notice is designed to remind broker-dealers of their obligations under these rules.

Governing Law

In order to understand the context in which FINRA issued the Notice, we summarize here the relevant Exchange Act rules and practices relating to contingencies in offerings. These rules are designed to ensure that investors are properly advised as to the nature of the contingency and that the purchase price of the securities is properly remitted to the issuer or back to the investor, as applicable.

Rule 10b-9. Rule 10b-9 applies to offerings other than firm commitment underwritings and provides that it is a deceptive practice to represent:

- that a security is being offered on an "all-or-none" basis, unless the offering is conditioned on all or a specified amount of the purchase price being promptly refunded to the purchaser; or
- that a security is being offered or sold on any other basis in which all or part of the purchase price will be returned to the purchaser if all or some of the securities are not sold, unless the offering is conditioned on all or part of the purchase price being promptly refunded to the purchaser

unless, in either case, (a) all of the securities are sold at a specified price within a specified time and (b) the amount due to the seller is received by a specified date.

Rule 15c2-4. This rule provides that if an offering (other than a firm commitment offering) is made on an "all-or-none" basis, or on any other basis that is subject to a contingency (i.e., a "minimum-maximum" or "min-max" deal), (a) the purchase price must be promptly deposited into a separate bank account until the contingency has occurred, and (b) the funds must be held by a bank under a written escrow agreement. FINRA has permitted certain other types of entities to serve as escrow agents.

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Impact of These Rules. These rules often apply in PIPE transactions if the offering is structured as an all-or-none or min-max deal (as opposed to an "any-or-all" deal), as well as to registered direct offerings unless these are structured as any or all deals. Under these rules, an unaffiliated bank is retained to act as escrow agent in order to hold the investor funds. Once the conditions are satisfied, such as the receipt of funds for all of, or for the minimum specified amount of, the offered securities, the bank will release the purchase price to the issuer. If the contingency is not satisfied, the offering will not close and the escrow agent will release the funds to the investors.

Review of Offering Documents by Broker-Dealer

Review of Contingency. In the Notice, FINRA reminds broker-dealers that it expects them to conduct a reasonable investigation of the security and the issuer's representations about the security. If the offering is a contingency offering, the investigation must include a review of the terms of the contingency, including any agreement and any disclosure documents that describe the contingency.

The Problem. In several offerings, FINRA found that the broker-dealer did not identify inconsistencies between the escrow agreement and the offering document as it relates to the requirements of the contingency. According to FINRA, these inconsistencies should be "red flags" to a broker-dealer performing a reasonable investigation that there is a problem that needs to be fixed.

In practice, counsel that prepares or reviews private placement documents will typically match up the terms of the escrow agreement and the disclosures about the escrow agreement that are set forth in any offering memorandum.

Changing the Contingency

FINRA indicated in the Notice that broker-dealers violated Rule 10b-9 by failing to return subscriber funds after the issuer changed the contingency, such as by reducing the minimum offering size. FINRA also found that broker-dealers violated the rule by failing to take the proper steps when an issuer extended the offering period. In each such case, FINRA's guidance is that the broker-dealers cannot unilaterally agree on behalf of investors to a change in the contingency or to extend the offering period; instead, investors should affirmatively agree to any such change. If they do not so agree, their subscription funds should be returned.

Non-Bona Fide Sales

"Non-bona fide sales" are sales of undisclosed purchases by the issuer or broker-dealer, their affiliates or associated persons, or any entities through nominee accounts that are designed to create the appearance of a successful completion of an offering. An issuer may improperly (and possibly fraudulently) engage in this practice, for example, if it is unable to identify investor interest sufficient to satisfy the minimum contingency for the offering. For example, FINRA identified a case in which an issuer attempted to satisfy the contingency by counting non-*bona fide* sales made to its own employees. In another case, FINRA found that an issuer used the proceeds from a loan to purchase some of the offered securities in order to meet the minimum offering amount.

In practice, broker-dealers should be vigilant so as to ensure that only proper purchases are counted towards meeting the contingency.

Failure to Disburse/Improper Disbursement

Notwithstanding the requirements of Rule 10b-9, FINRA identified cases in which investors did not receive their money back promptly, or at all, when the contingency did not occur. In addition, some broker-dealers disbursed

investor funds to issuers before the contingency was satisfied. Similarly, FINRA identified contingency offerings in which the broker-dealer instructed investors to send their funds directly to the issuer, instead of depositing them into an escrow account. FINRA warned broker-dealers in the notice that this could be a fraudulent practice.

Conclusion

As indicated in its annual priorities letter, FINRA is continuing to review private placements and whether broker-dealers are complying with their obligations in connection with these offerings. Correct documentation and procedures for escrow arrangements are just one set of obligations that broker-dealers must carefully follow in these offerings.

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