Proskauer

FINRA Proposes Amendment To Expand The Scope Of Rule 5122

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Financial Industry Regulatory Authority ("**FINRA**") Rule 5122 regulates member firms (or its control entities[1], collectively ("**Members**")) that issue unregistered securities of such Member.[2] In a sign of increased interest by FINRA into private placements,[3] on January 11, 2011, FINRA issued Regulatory Notice 11-04,[4] proposing to extend the reach of FINRA Rule 5122 (the "**Rule**") to any private placement in which a Member "*participates*."

If the amendments are adopted, as currently proposed, Members will be required to file the private placement memorandum, term sheet or other offering circular (the "**Offering Document**") for any private placement in which such Members participate. However, the Rule includes a number of important exceptions that substantially reduce the Members' burden, particularly with respect to securities offerings that are limited to institutional investors.

Set forth below is a summary of Rule 5122 as it is currently constituted, and as proposed to be amended by FINRA.

Background and Current Rule 5122

FINRA Rule 5122 was developed in response to abuses in the sale of private placements issued by Members and their Control Entities. Subject to certain exemptions, a Member firm engaging in a private placement of unregistered securities issued by the firm (or a Control Entity) is required to: (i) disclosure to investors in an Offering Document the intended use of proceeds, the offering expenses and the amount of compensation that will be paid to the Member and its associated persons; (ii) file the Offering Document with FINRA's Corporate Financing Department at or prior to the time it is provided to any prospective investor; and (iii) comply with the requirement that at least eighty-five percent (85%) of the offering proceeds raised 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]

Proposed Changes

As part of the ongoing reform of the financial services industry, FINRA proposed amendments to Rule 5122, which, if adopted, would greatly increase a Member firm's disclosure requirements to include those instances where the Member firm "*participates*" in the offering, subject to certain specified exemptions (below), whether or not it is the issuer.

Participation

The definition of the term "participation" is incorporated from FINRA Rule 5110, which refers to the performance of services that a Member firm typically provides in a private placement. Such services include (i) preparation or distribution of the Offering Documents, (ii) furnishing customer or broker solicitation lists and (iii) advisory or consulting services related to the offering; but specifically exclude the preparation of an appraisal in a savings and loan conversion or bank offering, or the preparation of a fairness opinion pursuant to SEC Rule 13e-3.

Disclosure Requirements

In association with the Rule's increased scope, FINRA proposes to increase disclosure requirements to include, in addition to all existing requirements, the disclosure of *any compensation* (as opposed to "*selling compensation*" in the existing rule) paid to the participating Member, as well as the disclosure of any potential conflict of interest arising out of any affiliation between the participating FINRA Member and the issuer. The requirements to file the Offering Document with FINRA and to use no less than eighty-five percent (85%) of the proceeds for business purposes remain unchanged.

Filing With FINRA

Under the proposed amendments, as under the current rule, an Offering Document for any private placement subject to the Rule must be filed with FINRA at or prior to the first time it is provided to a prospective investor. As under the current rule, the filing requirement would not impose any delay in the offering.

Exemptions

With respect to exemptions, FINRA's only proposed change is to eliminate the exemption for offerings in which the Member firm acts as a wholesaler. FINRA cites several recent enforcement cases in which a broker-dealer affiliated with an issuer acted as a wholesaler, indicating a need for increased investor protection. Further, the expanded reach of the Rule to all private placements means the reliance on the efforts of independent broker-dealers is no longer relevant. All other exemptions remain available, which are set forth below:

(1) Offerings sold to:

(a) *Institutional Accounts*, as defined in NASD Rule 3110(c)(4)[6];

(b) *Qualified Purchasers*, as defined in Section 2(a)(51)(A) of the Investment Company Act[7];

(c) *Qualified Institutional Buyers ("QIBs")*, 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 QIBS; 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 of exempt securities with short term maturities under Section 3(a)(3) of the Securities Act;

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

(6) Offerings of "variable contracts," as defined in Rule 2320(b);

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

(8) Offerings of unregistered investment grade rated debt and preferred securities;

(9) Offerings to employees and affiliates of the issuer or its control entities;

(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;

(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;

(12) 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

(13) Offerings filed with the Department under Rules 2310, 5110 or Rule 5121.

Conclusion

While the scope of the proposed Rule change is significant, it should not have a substantial impact on practices with respect to private placements in which the investor(s) or the transaction fall into one of the above-listed exceptions, particularly offerings to institutional accounts, QIBs, qualified purchasers, investment companies and banks, as well as offerings pursuant to Rule 144A or Regulation S, and offerings to employees and affiliates of the issuer. In view of this, offering participants should ensure that their offering or its investors fall into one of the above-listed exemptions. Conversely, if an offering or the investors do not fall into one of the above-listed exemptions, then the participating Member will be subject to the new Rule, if adopted, and its requirements.

[1] A control entity is any entity that controls or is under common control of a member firm or its associated persons.

[2] Click here to see Proskauer Client Alert of August 2008 for a more complete discussion of current Rule 5122.

[3] FINRA signaled its increased interest via its Regulatory Notice 10-22, which was intended to remind and describe the diligence required of FINRA members engaged in private placements.

[4] Available at: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p12278 .

[5] 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.

[6] Defined as: the account of: (A) a bank, savings and loan association, insurance company, or registered investment company; (B) an investment adviser registered either with the Securities and Exchange Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (C) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.

[7] Defined as: (i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) [15 USCS § 80a-3(c)(7)] with that person's qualified purchaser spouse) who owns not less than $ 5,000,000 in investments, as defined by the Commission; (ii) any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons; (iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or (iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments.