

Member Private Offerings

SEC Approves New FINRA Rule 5122 Relating to Private Placements of Securities Issued by a Member Firm or a Control Entity

Effective Date: June 17, 2009

Executive Summary

Effective June 17, 2009, new FINRA Rule 5122 will require FINRA member firms and associated persons that engage in a private placement of such firm's securities or those of a control entity (member private offering or MPO) to comply with certain disclosure and filing requirements and limitations of the use of proceeds.¹

The new rule provides additional regulation of certain private placements, which are generally excluded from the scope of existing rules, including FINRA Rule 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements) and NASD Rule 2720 (Distribution of Securities of Members and Affiliates – Conflicts of Interest), because these existing rules generally apply only to public offerings.² The text of FINRA Rule 5122 is set forth in Attachment A of this *Notice*.

The rule will not apply retroactively to any offerings that have already commenced selling efforts as of the effective date, June 17, 2009.

Questions concerning this *Notice* should be directed to:

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Notice Type

- Rule Amendment

Suggested Routing

- Corporate Financing
- Executive Representation
- Legal and Compliance
- Operations
- Senior Management

Key Topic(s)

- Affiliates
- Control Entity
- Institutional Accounts
- Member Private Offerings
- Private Placements
- Private Placement Memorandum
- Regulation D

Referenced Rules & Notices

- FINRA Rule 5110
- FINRA Rule 5122
- NASD Rule 2720
- NASD Rule 2810
- NASD Rule 3110

Background & Discussion

The offering of securities by a member firm or a control entity of the firm in a private placement raises conflicts of interest and has been an area of regulatory concern in recent years. To address these concerns, FINRA Rule 5122 requires a member firm or associated person that engages in a private placement of unregistered securities issued by the firm or a control entity of such firm to:

- (1) disclose to investors in a private placement memorandum, term sheet or other offering document the intended use of offering proceeds and the offering expenses;
- (2) file such offering document with FINRA's Corporate Financing Department at or prior to the time it is provided to any investor; and
- (3) commit that at least 85 percent of the offering proceeds will be used for business purposes, which shall not include offering costs, discounts, commissions and any other cash or non-cash sales incentives.

Definitions

Rule 5122(a) provides a set of definitions for the application of the rule. The term "member private offering" means a private placement of unregistered securities issued by a member firm or control entity. The term "private placement" is defined as a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act. A "control entity" is any entity that controls or is under common control with a member firm, or that is controlled by a firm or its associated persons. "Control" means a 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.

The power to direct the management or policies of a corporation or partnership alone (*e.g.*, the general partner of a partnership)—absent meeting the majority ownership or right to the majority of profits—would not constitute "control" as defined in Rule 5122. Performance and management fees earned by a general partner should not be included in the determination of partnership profit or loss percentages for purposes of the rule. However, if such performance and management fees are subsequently re-invested in the partnership, thereby increasing the general partner's ownership interest, then such interests should be considered in determining whether the partnership is a control entity.

In addition, for purposes of this rule, entities may calculate the percentage of control using a “flow through” concept by looking through ownership levels to calculate the total percentage of control. For example, if member firm ABC owns 50 percent of corporation DEF that in turn holds a 60 percent interest in corporation GHI, and ABC is engaged in a private offering of GHI, ABC would have a 30 percent interest in GHI (50 percent of 60 percent), and thus GHI would not be considered a control entity under this definition.

The determination of control should be made immediately after the closing of an offering. For example, if member firm ABC has an 80 percent ownership interest in corporation DEF and sells 50 percent of the shares it owns in DEF in a private placement, member firm ABC’s ownership interest in DEF immediately after the closing would be 40 percent and below the threshold of Rule 5122. However, if the member firm elects to conduct the private placements in stages, Rule 5122(a)(3) requires that determination of control be made after each such offering closes. For example, if member firm ABC elects to sell 50 percent of its interest in DEF in two stages, Rule 5122 would apply to the first offering as ABC would retain a 60 percent interest in DEF upon the closing of the first offering and DEF would still be considered a control entity. The subsequent offering would reduce ABC’s ownership interest in company DEF to 40 percent, and thus Rule 5122 would not apply to the subsequent offering.

If an offering is intended to raise sufficient funds such that the firm would not control the entity raising capital under the control standard, but fails to raise sufficient funds, the firm must promptly come into compliance with the rule, including providing the required disclosures to investors, filings with FINRA and limitations on the use of offering proceeds as discussed below.³

Rule 5122 applies to MPOs, and is intended to address potential conflicts and abuses that can occur when a member firm sells its own securities or those issued by a control entity. Accordingly, the provisions of the rule do not apply when the firm with the conflict does not offer or sell the securities, and the securities are instead sold by another member firm. For example, the rule does not apply if member firm ABC sells all of the securities issued by member firm DEF in an MPO unless member firm ABC is also a control entity of member firm DEF. If DEF offers or sells any of the securities, however, then the rule would apply (unless the MPO qualifies for an available exemption from the rule).

Disclosure Requirements

FINRA believes that every investor in an MPO should receive basic information concerning the offering. Consequently, Rule 5122(b)(1) requires firms to provide a written offering document to each prospective investor in an MPO, whether or not accredited, and that the offering document disclose the intended use of offering proceeds as well as offering expenses and selling compensation.⁴ If the 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 these disclosures. If the offering does not have a private placement memorandum or term sheet, then the member firm must prepare an offering document that discloses the intended use of offering proceeds as well as offering expenses and selling compensation. The rule does not require a particular form of disclosure.⁵

Filing Requirements

Rule 5122(b)(2) requires that a member firm file a private placement memorandum, term sheet or other offering document with FINRA's Corporate Financing Department at or prior to the first time such document is provided to any prospective investor. The firm must also file any amendments or exhibits to the offering document with FINRA within ten days of being provided to any investor or prospective investor. The filing requirement is intended to allow FINRA staff to identify those offering documents that are deficient "on their face" from the other requirements of the rule. Notably, the filing requirement differs from that in Rule 5110 (Corporate Financing Rule) in that FINRA staff will not review the offering and issue a "no-objections" letter before a member may commence the offering.

Offering documents should be submitted as PDFs to the Corporate Financing Department via email at corpfin@finra.org.⁶ Firms must include their CRD number for identification purposes as part of their email submission. As provided in the rule, information filed with FINRA pursuant to FINRA Rule 5122 will be subject to confidential treatment.⁷ In addition, the rule imposes no additional requirements regarding the filing of advertisements or sales materials, which continue to be governed by NASD Rule 2210.

Use of Offering Proceeds

Rule 5122(b)(3) requires that each time an MPO is closed at least 85 percent of the offering proceeds raised be used for business purposes (excluding offering costs, discounts, commissions or any other cash or non-cash sales incentives). The use of offering proceeds also must be consistent with the required disclosures to investors, as described above. This requirement was created to address abuses where firms or control entities used substantial amounts of offering proceeds for selling compensation and related party benefits, rather than business purposes. The rule, however, does not limit the total amount of underwriting compensation, although no more than 15 percent of the money raised from investors in the private placement could be used to pay underwriting expenses.⁸ This percentage is consistent with the limitation of offering fees and expenses, including compensation, in NASD Rule 2810 (Direct Participation Programs),⁹ and the North American Securities Administrators Association (NASAA) guidelines with respect to public offerings subject to state regulation.

Exemptions

Rule 5122(c) provides a number of exemptions from the rule based on type of offerings and type of investors. First, the rule exempts MPOs sold solely to the following:

- institutional accounts, as defined in NASD Rule 3110(c)(4);
- qualified purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act;
- qualified institutional buyers, as defined in Securities Act Rule 144A;
- investment companies, as defined in Section 3 of the Investment Company Act;
- an entity composed exclusively of qualified institutional buyers, as defined in Securities Act Rule 144A; and
- banks, as defined in Section 3(a)(2) of the Securities Act.

In addition, Rule 5122 excludes the following types of offerings, which do not raise the concerns raised by previous FINRA enforcement actions:

- offerings of exempted securities, as defined by Section 3(a)(12) of the Exchange Act;
- offerings made pursuant to Securities Act Rule 144A or SEC Regulation S;
- offerings in which a firm 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 percent of the securities in the offering);
- offerings of exempted securities with short term maturities under Section 3(a)(3) of the Securities Act;
- offerings of subordinated loans under SEA Rule 15c3-1, Appendix D¹⁰;
- offerings of “variable contracts,” as defined in NASD Rule 2820(b)(2);
- offerings of modified guaranteed annuity contracts and modified guaranteed life insurance policies, as referred to in Rule 5110(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 Rule 5110 or NASD Rules 2720 or 2810.

Finally, the rule exempts the following types of MPOs, in which investors are expected to have access to sufficient information about the issuer and its securities, in addition to the information provided by the firm conducting the MPO:

- 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 made to existing investors without the need for additional consideration or investments on the part of the investor.

Types of exemptions may be combined without triggering the requirements of the rule. For example, if an MPO is offered to both qualified purchasers and employees or affiliates of the issuer or its control entities, as long as these purchasers qualify for exemptions under the rule, the MPO would be exempt from the rule's requirements.

Endnotes

- 1 See Exchange Act Release No. 59599 (March 19, 2009), 74 FR 12913 (March 25, 2009) (SR-FINRA-2008-020) (MPO Approval Order).
- 2 FINRA Rule 5110 and NASD Rules 2720 and 2810 govern member firm participation in public offerings of securities.
- 3 For example, if member firm ABC intends to sell 50 percent of its 80 percent interest in (or 40 percent of) corporation DEF, but fails to obtain enough purchasers and subsequently amends its offering to sell only 25 percent of its 80 percent interest (or 20 percent), then ABC must promptly come into compliance with the rule. The fact that ABC believed that DEF would not be a control entity upon the completion of the offering does not excuse its obligation to comply with the terms of Rule 5122.
- 4 FINRA recognizes that changing the business purpose or use of proceeds in an offering may in some instances benefit investors, and reminds firms that they may change the use of proceeds, provided they make appropriate disclosures to investors and file amended offering documents with the Corporate Financing Department.
- 5 See Supplementary Material 5122.01.
- 6 The Department's mailbox may also be accessed through the FINRA Web site at www.finra.org/Industry/Compliance/RegulatoryFilings/index.htm. The offering documents will be deemed filed for purposes of the rule upon email submission to this mailbox. An email response will be generated by the Department to notify filers that the MPO filing has been received. Because the Department will not issue a "no-objections" letter before a firm may commence the offering, firms should maintain records evidencing their submission of offering documents.
- 7 See Rule 5122(d). This confidential treatment provision is similar to that provided in Rule 5110(b)(3).
- 8 See MPO Approval Order.
- 9 FINRA has proposed transferring NASD Rule 2810 without material change into the Consolidated FINRA Rulebook as FINRA Rule 2310. See SR-FINRA-2009-016.
- 10 Firms' offerings of subordinated loans are subject to an alternative disclosure regime. In 2002, the SEC approved a rule change to require, as part of a subordination agreement, the execution of a Subordination Agreement Investor Disclosure Document. See Exchange Act Release No. 45954 (May 17, 2002), 67 FR 36281 (May 23, 2002); see also *Notice to Members 02-32* (June 2002).

ATTACHMENT A

The following is the text of new Rule 5122.

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5000. SECURITIES OFFERING AND TRADING STANDARDS AND PRACTICES

5100. SECURITIES OFFERINGS, UNDERWRITING AND COMPENSATION

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5120. Offerings of Members' Securities

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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.

(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 in a Member Private Offering 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 disclosures addressing:

(i) intended use of the offering proceeds; and

(ii) offering expenses and the amount of selling compensation that will be paid to the member and its associated persons.

(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 the private placement memorandum, term sheet or such other offering document 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, at least 85% of the offering proceeds raised must be used for business purposes, which shall not include offering costs, discounts, commissions or any other cash or non-cash sales incentives. The use of the offering proceeds also must be consistent with the disclosures required in paragraph (b)(1).

If, in connection with the offer and sale of any security in a Member Private Offering, a member or associated person discovers after the fact that one or more of the conditions listed above 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 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) offerings of exempted securities with short term maturities under Section 3(a)(3) of the Securities Act;
- (6) offerings of subordinated loans under SEA Rule 15c3-1, Appendix D (see NASD Notice to Members 02-32 (June 2002));
- (7) offerings of “variable contracts,” as defined in NASD Rule 2820(b)(2);
- (8) offerings of modified guaranteed annuity contracts and modified guaranteed life insurance policies, as referenced in Rule 5110(b)(8)(E);
- (9) offerings of unregistered investment grade rated debt and preferred securities;

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

(11) 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) 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) 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

(14) offerings filed with the Department under Rule 5110 or NASD Rules 2720 or 2810.

(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 person associated with a member from the provisions of this Rule for good cause shown.

• • • Supplementary Material: -----

.01. Private Placement Memorandum. Nothing in this rule shall require a member to prepare a private placement memorandum. A member may satisfy the disclosure and filing requirements in the Rule with an offering document that does not meet the additional requirements of Securities Act Rule 502.

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