Portfolio Media, Inc. | 648 Broadway, Suite 200 | New York, NY 10012 | www.law360.com
Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Implications Of FINRA Rule 5122

Law360, New York (October 23, 2009) -- The stresses in the commercial real estate and oil and gas industries in the recent past have required the full concentration of sponsors, broker-dealers and investors in the direct participation private placement market. Much of this product, particularly commercial real estate and oil and gas royalty interests, is sold through the tenant-in-common distribution channel.

While the sponsors, broker-dealers and investors have been forced to focus more on resolving existing problems than on new sales or planning for the future, some observers of the problems, notably government regulators and or quasi-governmental regulators such as the U.S. Securities and Exchange Commission and Financial Industry Regulatory Authority, have increasingly focused on tightening the controls on participants in the private placement marketplace.

While some of these regulatory initiatives may provide necessary curbs on abuses, others may cast too wide a net and produce unintended consequences, or consequences that are greater than is necessary to curb alleged abuses.

One example of this may be the recent adoption of FINRA Rule 5122, relating to private placements of securities by "a member firm," i.e., a broker-dealer issuing securities in itself or by a "control entity." (See FINRA Regulatory Notice 09-27)

The thrust of the rule is to require that 85 percent of the proceeds of a "member private offering" must be used "for business purposes, which shall not include offering costs, discounts, commissions or other cash or noncash sales incentives."

The term "member private offering" includes a private placement of securities by a "control entity" of a broker-dealer. There are two definitions for "control."

The first is beneficial ownership of more than 50 percent of the outstanding voting securities of a corporation. The second is the right to more than 50 percent of the

distributable profits or losses of a partnership or noncorporate entity. Both tests are determined "immediately following each closing."

The rule clearly appears to apply to offerings by a broker-dealer of its own securities or of securities issued by an affiliate where the affiliate will retain more than 50 percent of the voting securities or the right to more than 50 percent of the distributable profits of the broker-dealer or broker-dealer affiliate after the closing.

This does not appear to pose a problem for an offering by a preclosing affiliated entity, i.e., the typical real estate or oil and gas offering of interests in a partnership or LLC where after the offering closes the member affiliate retains less than 50 percent of the voting securities or distributable profits.

Unfortunately, the rule also apparently applies to real estate or oil and gas royalty or working interest fractional direct participation offerings by sponsors affiliated with a broker-dealer, i.e., sponsors with a captive broker-dealer.

The problem is that immediately after the offering, the sponsor will have sold well in excess of 50 percent of the fractional interests, but it has not sold interests in itself. In other words, the sponsor is still in the control group.

It is unlikely that FINRA intended to limit sponsors of direct participation offerings to 15 percent of total offering proceeds if they sell through a "captive" broker-dealer.

It is an unintended but serious consequence to sponsors of such offerings, who routinely take more than 15 percent of offering proceeds after factoring in commissions earned by a captive broker-dealer and the costs of the offering.

There is an exemption if the captive broker-dealer 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."

The meaning of this provision is not entirely clear. Does it mean that the captive broker-dealer may not wholesale more than 20 percent of the securities, or does it mean that the captive cannot earn a full retail commission on more than 20 percent of the securities?

The latter seems more likely. If so, some captives typically function primarily as wholesalers and would not be expected to earn a retail commission on more than 20 percent of the securities, thus exempting them. However, that is not always the case. Many captive broker-dealers sell aggressively and directly in the retail market.

Will this mean the end of the captive broker-dealer in the real estate and oil and gas direct participation private placement market? Perhaps not, but it will likely push them more in the direction of acting as pure wholesalers. Was that what FINRA intended? It seems unlikely.

--By Stephen I. Burr, Foley & Lardner LLP

Stephen Burr is a partner with Foley & Lardner in the firm's Boston office.

The opinions expressed are those of the author and do not necessarily reflect the views of Portfolio Media, publisher of Law360.