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The New FINRA Rule 5122—A New Approach to Market Regulation?

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The stresses in the private placement securities industry in the recent past have required the full concentration of sponsors, broker-dealers, and investors. Much of this product, particularly commercial real estate and oil and gas royalty interests, is sold through an organized broker-dealer 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 Securities Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA), have increasingly focused on tightening the controls on participants in the private placement marketplace.

One example of this may be the recent adoption of FINRA Rule 5122 (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."

RULE 5122

One of the key provisions of Rule 5122 is to require that 85 percent of the proceeds of a Member Private Offering (MPO) must be used "for business purposes, which shall not include offering costs, discounts, commissions or other cash or non-cash sales incentives."[1] 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 non-corporate entity. Both tests are determined "immediately following each closing."[2]

FINRA points out that "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."[3] For the purpose of determining control "performance and management fees earned by a general partner" are not considered part of the includable "profits" unless such performance and management fees are "subsequently re-invested in the partnership, thereby increasing the general partner's ownership interest."[4]

What is the problem that FINRA is trying to address? Beginning in 2005, FINRA brought a series of enforcement cases concerning abuses in MPOs.[5] Among the allegations in these cases were that members failed to provide private placement memorandums (PPMs) to investors, or provided PPMs that contained misleading, incorrect, or selective disclosure, such as omissions and misrepresentations regarding selling compensation and the use of offering proceeds. The unity of interest between the issuer and the broker-dealer removes a layer of protection for investors, as the broker-dealer, in FINRA's estimation, should be an advocate for the investor and conduct due diligence on the investor's behalf. While this concern is laudatory, as long as the manner of compensating broker-dealers is commission-based, *i.e.*, the broker-dealer earns revenue only if it sells securities to the investor, the alignment of interests between investors and broker-dealers remains stressed.

What is more problematic is how FINRA decides to address the inherent conflict of interest in an MPO. The first requirement is certainly consistent with traditional regulatory supervision: The issuing broker-dealer or controlled entity must prepare a private placement memorandum or "term sheet" which includes, among other things, disclosures concerning "the intended use of the offering proceeds" as well as "offering expenses and the amount of selling compensation that will be paid to the member and its associated persons."[6] There is nothing unusual about this requirement—private placement memoranda routinely have a use of proceeds table as well as a "compensation to the sponsor and affiliates" disclosure.

The second requirement is in effect a notice filing of the offering with the Corporate Financing Department of FINRA.[7] Although there is undoubtedly some *in terrorum* impact of forcing this filing on broker-dealer issuers, it does not amount to a requirement of substantive pre-offering review. However, these filings may be used to make referrals to FINRA's Enforcement Department if the terms or disclosure are deemed violative of Rule 5122 or any other provision of the federal securities laws or FINRA's rules.

The third requirement imposed by FINRA on MPOs is more substantive. The rule requires that "at least 85 percent 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."[8] FINRA's comment on this section of the rule is illuminating:

> 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.[9]

The language of Section (b)(3) is a bit confusing. What are "business purposes"? In the context of the whole provision this phrase appears simply to mean for purposes other than compensation to the broker-dealer issuer and affiliates. Presumably a generic "for working capital purposes" would meet this standard. FINRA's commentary advises:

> 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.[10]

This seems a bit of an oxymoron. What is the difference between "underwriting compensation" and "underwriting expenses"? Can a broker-dealer charge total offering expenses and commissions of 15 percent and the affiliated issuer charge a "closing" or "acquisition fee" above that? The language quoted above to the effect that "performance and management fees earned by a general partner" are not counted against the 15 percent suggests that affiliate fees that are tied to performance, *e.g.*, fees earned specifically for or upon acquisition of assets, closing of debt financing or for asset management are not limited. This would also suggest that issuer fees charged at the closing of the offering that are not charged for "performance" but are more in the nature of success fees for completion of the offering may count against the 15 percent limit.

One wonders about the consistency of this type of compensation restriction with the general thrust of the securities laws and FINRA's mandate to regulate the broker-dealer industry, which, of course, is to encourage accurate and complete disclosure, not to dictate the terms of the offering. FINRA's comment on this did not suggest that this was a fundamental change in their approach to market regulation:

> This percentage [the 15% limit] is consistent with the limitation of offering fees and expenses, including compensation, in NASD Rule 2810 (Direct Participation Programs) and the North American Securities Administrators Association (NASAA) guidelines with respect to public offerings subject to state regulation.[11]

However, there is one distinct group of broker-dealers, so-called captive broker-dealers, for which the new 15 percent restriction may have significant implications.

THE RULE OF UNINTENDED CONSEQUENCES—RULE 5122 AND CAPTIVE BROKER-DEALERS

As discussed above, Rule 5122 appears clearly 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 with respect to an offering by a pre-closing affiliated entity, *i.e.*, the typical offering of interests in a partnership or limited liability corporation where after the offering closes the member affiliate retains less than 50 percent of the voting securities or distributable profits.

Unfortunately, Rule 5122 also apparently applies to direct participation offerings by sponsors affiliated with a broker-dealer, *i.e.*, sponsors with a captive broker-dealer. The problem is that in a direct participation offering immediately subsequent to the offering the sponsor will have sold well more than 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, the costs of the offering and (assuming they are to be included) other fees payable to the sponsor on successful completion 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."[12] 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 this is 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, making them exempt. However, that is not always the case. Many captive broker-dealers sell aggressively directly in the retail market.

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

PARTIALLY COMPLETED OFFERINGS; STAGED OFFERINGS

In times when capital raising is difficult, it is not unusual for offerings to close before the "maximum offering amount" is raised, or for offerings to be "staged," *i.e.*, organized in distinct steps. This may raise complications, both in determining the test of post-offering control and in applying the 15 percent offering expense cap. FINRA provides one example:

> 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.

EXEMPTIONS

There is a long list of exemptions to Rule 5122, primarily directed to the sophistication and knowledge of the investor.[13] Before spending time trying to figure out compliance with Rule 5122 it makes sense to review the exemptions carefully, *e.g.*, the exemption applicable to wholesaling activities described above.

CONCLUSION

Does Rule 5122 suggest a new, tougher era of FINRA regulation? Viewed in isolation, probably not. However, viewed in the context of its larger review of existing regulations and its pending investigation and enforcement actions, it does suggest that FINRA is increasingly sensitive to maintaining an appropriate distinction between acting as an issuer and acting as a broker-dealer. One result likely will be closer scrutiny of captive broker-dealers who are aggressive sellers at the retail level. Given recent history, it is hard to argue with that focus.

NOTES

1. Rule 5122(b)(3).
2. Rule 5122(a)(3).

3. FINRA, Regulatory Notice 09-27 "Definitions."
4. *Id.*
5. *See*, Franklin Ross, Inc., summarized in NASD Notice Disciplinary Actions, p. 1 (May 2006); Capital Growth Financial, LLC, summarized in NASD Notice Disciplinary Actions, p. 1 (April 2006); Craig & Associates, Disciplinary Actions, p. D6 (October 2005).
6. Rule 5122(b)(1)(A)(ii).
7. Rule 5122(b)(2).
8. Rule 5122(b)(3).
9. FINRA, Regulatory Notice 09-27, "Use of Offering Proceeds."
10. FINRA Regulation Notice 09-27, "Use of Offering Proceeds."
11. FINRA Regulatory Notice 09-27 "Use of Offering Proceeds."
12. Rule 5122(c)(4).
13. Rule 5122(c).

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