

FINRA Rule 5122 – Private Offerings by FINRA Member Affiliates and the Imposition of Merit-Based Requirements in Federal Securities Law

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Disclosure-based securities regulation has been the hallmark of federal securities regulation for securities issuers since the adoption of the Securities Act of 1933. But, with the SEC's approval of FINRA Rule 5122 on March 19, 2009, disclosure-based securities regulation has taken a back seat to new merit-based requirements for issuers that are control affiliates of FINRA members. Regardless of whether FINRA Rule 5122's new merit-based requirements are actually meritorious, the new rule provides a philosophical shift in securities regulation for issuers to a merit-based approach. Given the regulatory ferment caused by the current financial crisis, Rule 5122's merit-based approach may be a harbinger of things to come, especially in other SRO rules.

Rule 5122 provides that it is a violation of law for an FINRA member to issuer or associated person conduct a private offering of its own securities or the securities of an issuer under common control with the broker-dealer or associated person under any circumstances unless at least 85% of the offering proceeds raised are used for the business purposes identified in the "intended use of offering proceeds" disclosure in the offering documents. This limit is in force regardless of whether the use of proceeds is extensively disclosed. Thus, for FINRA members and their control affiliates, solely issuer disclosure-based securities regulation has ended.

Importantly, Rule 5122 has limited applicability. It applies only to offerings sold by the broker-dealer member. It also only applies if the broker-dealer or control affiliate owns 50% or more of the voting securities of the issuer corporate entity or 50% or more of an issuer partnership or joint venture's distributable profits and losses. Thus, articles of incorporation or limited liability company agreements for corporate entities can be structured to keep the voting securities below 50% thus falling outside of Rule 5122. However, control affiliate can still maintain effective control of the enterprise through voting agreements covering equity securities that the affiliate does not own. For entities typically structured as non-corporate entities such as oil and gas projects, real estate developments, non-public REITS, and hedge funds, the controlling agreements can grant the control affiliate substantial real control provided that the distributable profits and losses due the control affiliate remain below 50%.

Rule 5122 requires that the control determination be made at the offering's first closing and each subsequent closing. So, control affiliate that have small or no minimum offering amounts are much more likely be covered by Rule 5122's provisions.

SUMMARY OF RULE 5122

FINRA Rule 5122 becomes effective on or before May 18, 2009. It requires issuer entities that are controlled by or under common control of a member and whom conduct a private offering to: 1) provide disclosures to each prospective investor about the issuer's intended use of the offering proceeds, the offering expenses and the selling compensation paid to the FINRA member and its associated persons;¹ 2) file offering documents with the FINRA Corporate Financing Department at, or prior to, the first time the offering documents are provided to a prospective investor;² and 3) dedicate at least 85% of the offering proceeds to the "business purpose identified in the intended use of offering proceeds disclosures in the disclosure documents and spend funds consistent with the use of proceeds disclosure."³ This business purpose shall not include offering costs, commissions, discounts, and any other cash or non-cash incentives.⁴

Control

FINRA Rule 5122 provides a limited standard for determining "control" of a member affiliate. The rule states that "control" means beneficial interest "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."⁵

Whether a business entity is controlled by or under common control of a FINRA member will be determined at each close of an offering, not at the beginning.⁶ Further, if there are multiple closings, whether the issuer fits within the definition of "control" with a FINRA member will be determined at each closing.⁷ The percentage ownership will be determined by a "flow-through" approach.

¹ FINRA Rule 5122(b)(2).

² FINRA Rule 5122(b)(1).

³ FINRA Rule 5122(b)(2).

⁴ FINRA Rule 5122(b)(2).

⁵ FINRA Rule 5122(a)(2).

⁶ FINRA Proposed Rule Change, SEC File No. SR-2008-20 (September 11, 2008), pages 12-13.

⁷ FINRA Rule 5122(a)(2).

For example, if broker-dealer ABC owns 50 percent of corporation DEF that in turn holds 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.⁸

Moreover, “the power to direct the management or policies of a corporation or partnership alone (e.g. a general partner) – absent meeting the majority ownership or right to a majority of profits – would not constitute control.”⁹ Finally, a general partner’s performance and management fees that are actually paid out would not be included in the determination of partnership profit or loss percentages.¹⁰ Performance and management fees that are re-invested in the partnership, however, would count as a “distributable profit or loss.”¹¹

The commentary in the FINRA rule proposal relating to performance fees¹² seems self-contradictory because of the rule’s focus on distributable profits rather than on investors’ capital accounts. Performance fees are almost always structured as shares of distributable profits and precisely fit within the control definition in Rule 5122. Consequently, broker-dealers should be cautious about relying on what the FINRA Staff said in its rule proposal in connection with performance fees. Performance fees can increase the distributable profit participation above Rule 5122’s 50% control threshold. For example, if a broker-dealer control affiliate owned 40% of a hedge fund with a 20% of profits performance fee that would give the control affiliate the right to 52%¹³ of the distributable profits. Such a performance fee would be squarely within Rule 5122’s control definition, no matter what the FINRA staff release says.

Rule 5122’s control provisions also provide no specific guidance about how to treat offerings that involve issuer back-in after payout provisions, a common structure in oil and gas and real estate offerings. “Back in after payout” means equity investors receive an enhanced distribution of profits until such time as investors have broken even or achieved some pre-determined return. At that point, the equity investors profit participations are diminished and the issuer or its affiliates begin to receive a designated amount of the distributable profits and losses which may be in excess of 50%. Given that

⁸ FINRA Proposed Rule Change, SEC File No. SR-2008-20 (September 11, 2008), page 12.

⁹ FINRA Proposed Rule Change, SEC File No. SR-2008-20 (September 11, 2008), page 12; FINRA Proposed Rule Change Amendment Two, SEC File No. SR-2008-20 (January 7, 2009), page 13.

¹⁰ FINRA Proposed Rule Change, SEC File No. SR-2008-20 (September 11, 2008), page 12; FINRA Proposed Rule Change Amendment Two, SEC File No. SR-2008-20 (January 7, 2009), page 13.

¹¹ FINRA Proposed Rule Change, SEC File No. SR-2008-20 (September 11, 2008), page 12.

¹² FINRA Proposed Rule Change, SEC File No. SR-2008-20 (September 11, 2008), page 12.

¹³ $(40\% \times 80\% = 32\%) + 20\% = 52\%$

the rule requires that the control determination be made at closing, the reasonable interpretation would be that the distributable profits and losses during the initial phase of the business entity govern the Rule 5122 control determination because that is the structure at each closing. Indeed, whether the business entity will ever make enough money to pay off investors and provide a back in payout to issuers or their affiliates is speculative and may never occur in many cases.

Disclosing Intended Use of Proceeds, Offering Expenses, and Selling Compensation

Rule 5122 requires broker-dealers disclose to prospective investors the “intended use of offering proceeds” and “the offering expenses and the amount of selling compensation.” This disclosure can be in a private placement, term sheet or such other offering document that contains these disclosures. The supplementary materials to Rule 5122 state:

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 502.¹⁴

“Offering expenses” are not specifically defined in Rule 5122, but the rule does state that the offering’s business purpose does not include offering costs, discounts, commissions or any other cash or non-cash sales incentives.¹⁵ FINRA Rule 2810 relating to public offerings of direct participation programs states that offering expenses include:

expenses incurred in preparing a direct participation program for registration and subsequently offering interests in the program to the public, including all forms of compensation paid to underwriters, broker/dealers, or affiliates thereof in connection with the offering of the program.¹⁶

Broker-dealers should assume that FINRA will interpret the term “offering expense” consistent with FINRA Rule 2810 and several Notices to Members interpreting this and similar rules.¹⁷ These expenses will undoubtedly include state notice filing fees for Regulation D offerings.

¹⁴ FINRA Rule 5122 Supplementary Materials

¹⁵ FINRA Rule 5122(b)(3).

¹⁶ FINRA Rule 2810(a)(12).

¹⁷ NTM 82-50, 82-51, 85-29, 86-66, 86-88, 86-16, 92-53, 93-44, 08-35.

A July 2008 Notice to Members stated that offering expenses typically include the following expenses in addition to the amounts paid to broker-dealers:

- 1) assembling and mailing offering materials, processing subscription agreements and generating advertising and sales materials;
- 2) legal and accounting services provided to the sponsor or issuer;
- 3) salaries and non-transaction-based compensation paid to employees or agents of the sponsor or issuer for performing services for the issuer;
- 4) transfer agents, escrow holders, depositories, engineers and other experts;
- 5) registration and qualification of securities under federal and state law, including taxes and fees and FINRA fees; and
- 6) Due diligence expenses.¹⁸

Filing Private Placement Memorandum with FINRA Corporate Financing Department

Rule 5122 requires that FINRA members file a copy of the private placement memorandum, term sheet, or other offering document with FINRA Corporate Financing Department at or prior to the first time the disclosure documents are provided to a prospective investor.¹⁹ Amendments and exhibits to the disclosure documents must also be filed within ten days of being provided to an investor.²⁰ Rule 5122 does not require that FINRA members receive a “no objections” letter from the FINRA Corporate Financing Department as required under NASD Rules 2710 and 2810.²¹ Rule 5122 requires that FINRA treat these filings as confidential.²² The filing system should be an online system similar to FINRA Corporate Financing Departments’s COBRADesk system.

The stated rationale for this filing requirement is “to allow the Department to identify those PPMs (or other disclosure document) that are deficient ‘on their face’ from the other requirements of the proposed rule change.”²³ Nevertheless, broker-dealers should expect that these filings will be used for exam and investigative purposes by FINRA and by other securities regulators. Indeed, since the stated purpose of the filing is to ensure compliance with Rule 5122 in the private placement memorandum’s use of proceeds section, the requirement to file exhibits which are irrelevant to use of proceeds

¹⁸ NTM 08-35 (July 2008)

¹⁹ FINRA Rule 5122(b)(1).

²⁰ FINRA Rule 5122(b)(1).

²¹ FINRA Proposed Rule Change, SEC File No. SR-2008-20 (September 11, 2008), page 13.

²² FINRA Rule 5122(d).

²³ FINRA Proposed Rule Change, SEC File No. SR-2008-20 (September 11, 2008), page 13.

disclosure in no way fulfills the stated purpose of the filing requirement. Examples of such exhibits could include geological reports, demographic marketing reports and ancillary contracts. Requiring the filing of these exhibits provides regulators access to this issuer information without making a FINRA document request subject to NASD Rule 8210.

Dedicating 85% of Offering Proceeds to “Business Purpose” of Offering

Most of Rule 5122’s requirements are disclosure-based requirements. Yet, requiring that 85% of the proceeds from a securities offering be used for the “business purpose” identified in the “intended use of the offering proceeds” disclosure in the disclosure documents²⁴ is a merit standard that is inconsistent with the general disclosure-based policy approach of federal securities regulation. Members and their associated persons could be in violation of law even if all uses of offering proceeds were clearly and comprehensively disclosed.

Rule 5122 requires that “the use of offering proceeds also must be consistent with” Rule 5122’s required use of proceeds disclosure and imposes an ongoing duty on broker-dealers to comply with Rule 5122 if it discovers after the fact that the issuer failed to meet the 85% business purpose or disclosed use of proceeds standards. For example, if a broker-dealer or associated person discovers that less than 85% of the offering proceeds actually went to the business purpose of the offering, the broker-dealer or associated person will be required to attempt to conform the offering to the necessary totals. This appears to require an ongoing obligation for the issuer to keep the broker-dealer apprised of the actual use of proceeds. Indeed, this may be a term that needs to be included in the selling agreement.

Rule 5122 does not define “business purpose,” but states that it does not include offering costs, commissions, discounts, and any other cash or non-cash incentives are not included.²⁵ This leaves several unresolved questions relating to the activities of a broker-dealer subsidiary when funds are raised for funds for a parent company. For example, assume that a broker-dealer shares office space with its parent holding company and has a FINRA-compliant expense agreement with its parent company. Is it a “business purpose” for the parent to directly or indirectly pay its broker-dealer subsidiary’s rent, phone systems, non-commissioned salaries, anti-money laundering examiner, auditor, outside compliance consultants, attorneys, industry arbitration claims, fidelity bond premium, minimum clearing fee, or any other non-sales related broker-dealer expense?

Rule 5122’s requires that members and associated persons who subsequently discover non-compliance with its use of offering proceeds standards cause the issuer to

²⁴ FINRA Rule 5122(b)(3).

²⁵ FINRA Rule 5122(b)(3).

conform to the Rule 5122 requirement. This causes problems. The member or associated person may not have any authority to effect a conforming change. Further, there are situations in which such conformity may be impossible to effect after the fact. For example, in an oil and gas offering with turnkey operations, if the offering expenses marginally exceed 15% on final accounting, how is this offering to be conformed? Because of the turnkey contracts, the investor funds already went to operations. If the general partner or joint venture manager needs to return money to the partnership or joint venture to again fit within the 85% rule, how can these funds be spent on intended operations to create conformity with Rule 5122? Depositing the funds in the partner's or joint venturer's capital account will not fulfill the business purpose because the turnkey contract price has already been paid. And the returned funds cannot go to operations because that would change the terms of the turnkey contract and require an amended offering document and consents from all investors.

Exemptions

FINRA exempted many private placements involving several products and classes of offerees from Rule 5122. But, the rule did not exempt accredited investors and offerings targeting accredited investors must comply with its provisions.

FINRA exempted from Rule 5122 offerings sold only to the institutional accounts, qualified institutional buyers and entities composed solely of qualified institutional buyers, registered investment companies, banks. It also exempted securities issued to acquire a bank holding company and savings associations, Rule 144A offerings (qualified institutional buyer), Regulation S offerings (offshore investors), wholesalers, short-term debt, subordinated loans to broker-dealers, variable annuities, modified guaranteed annuity and life insurance policies, investment grade debt and preferred stock, offerings to employees and affiliates, restructuring transactions involving a current securities holder, commodity pools, equity or credit derivatives not principally based on the

member or its affiliate, and offerings filed with the Department of Corporate Financing under other FINRA rules.²⁶

²⁶ FINRA Rule 5122(c) exempts:

- (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;
- (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 NASD Rule 2710(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 NASD Rules 2710, 2720 or 2810.

IMPACT OF RULE 5122

Increased Offering Minimums and Secondary Capital Calls – Hedge Funds and Oil and Gas Syndications

Rule 5122 requires the scope of coverage for control affiliate determination to be determined at each closing of the offering, i.e. each time funds become available to the issuer. Some offerings, especially in the hedge fund and oil and gas syndication arenas, have small or no minimum offering amounts. Some offerings have no escrow accounts at all and disclose that funds can be used from the first sale. Just about all of these offerings would initially be subject to Rule 5122's limitations. Thus, control affiliate will need to determine whether to increase minimum offering amounts and those issuers who have had no minimums will need to assess whether to impose minimum amounts. Broker-dealers should remember that SEC Rule 15c2-4 requires an independent escrow agent for a mini-max offering. Also the SEC's net capital rule, Rule 15c3-1(a)(2)(iii)(b), says that broker-dealers with less than \$100,000 minimum net capital should use a bank as independent escrow agent rather than a non-bank entity. Broker-dealers with \$100,000 or more minimum net capital may use a non-bank independent escrow agent.

Hedge funds, private equity funds, and oil and gas syndications also frequently require future capital commitments from investors. For example, a private equity fund may not seek to call for funds until they can be deployed. Oil and gas offerings generally have a second capital payment for well completion expenses should a drilled well test to produce sufficiently for commercial production. Indeed, gas wells may have pipeline completion costs that exceed the drill and test costs of the well.

Rule 5122 does not provide guidance if "offering proceeds" includes future required payments from investors or only the initial received funds. If, as typical, the full commission is paid from the initial payment, the percentage of funds used for the business purpose could be well below 85% of the initial payment, but be well above 85% if all required future capital calls are included. Thus, control affiliates contemplating offerings sold through the affiliated member with two or more required payments from investors should discuss this issue with their counsel.

Rewriting Issuer Articles and Agreements; Voting Agreements

Corporate entities who may face the prospect of being an affiliated issuer under Rule 5122 may consider revisiting their controlling documents such as the certificate or articles of incorporation for corporations and company agreements for limited liability companies. Business entities can segregate distribution of profits and losses from voting control by using different equity classes. If a corporate entity has a super-voting equity interest, the issuer may consider seeking equity owner approval to reclassify the voting rights so that the broker-dealer affiliate will no longer will hold a 50% ownership of the

voting securities, and thus not be within the ambit of Rule 5122. But, the broker-dealer affiliate could still possibly maintain effective control of the business entity through voting agreements wherein the non-affiliated equity owner is obligated to vote their interest as directed by the affiliated equity owner. Such agreements do not convey ownership and the non-affiliated equity owner can still vote a different way, but such a vote would cause that owner to be subject to the breach of contract remedies in the voting agreement.

Non-corporate entities, such as joint ventures, partnerships, and trusts are typical of oil and gas, real estate, and hedge fund syndications. In such syndications the syndicator typically does not have a right to the majority of the distributable profits or losses, and thus will not typically be covered by Rule 5122. But, the controlling agreements should be reviewed for this issue. Further, Rule 5122 does not address how to treat a carried interest held outside the non-corporate entity, such as a carried oil and gas working interest held directly in a lease held by an affiliate of the syndicator. Such an interest would not be a distributable profit or loss of the partnership or non-corporate legal entity. Likewise, real estate partnerships or REITS may pay various affiliates various fees for managing the entity, selling a property to the entity, securing a mortgage for the property, and other purposes. These contractual fees also do not appear to be part of “distributable profits or losses” because they are paid without regard to the business entity’s profits or losses.

Amendments to Selling Agreements

Rule 5122 will require broker-dealers to change the form of their selling agreements when the issuer is an affiliated entity. The selling agreement should include terms relating to compliance with Rule 5122. Importantly, the selling agreement should include a term requiring the issuer to help fulfill the broker-dealer’s ongoing duties under Rule 5122 to seek to ensure that 85% of the offering proceeds be used for the stated business purpose and that funds were spent consistently with the use of offering proceeds disclosure. The broker-dealer may consider requiring the affiliated issuer to provide an accounting of the use of proceeds of the offering to ensure conformity with Rule 5122.

Debt Issuances

While, as stated above, affiliated equity offerings have various ways of avoiding the control provisions of Rule 5122, debt offerings do not. Consequently, member-control affiliate will generally need to comply with Rule 5122 in debt offerings, including convertible debt offerings.

Lowering Margins and Commissions

By effectively limiting offering costs and selling expenses to 15%, Rule 5122 may lower the profit margins for certain transactions. Whereas previously affiliated broker-dealers may have paid substantial commissions to brokers and then been reimbursed by the issuer for offering costs, now both of those expenses will come from the same bucket. Since the cost of printing, postage, phones, and other offering expenses will be paid from that 15% portion of the offering, this may effectively cause a reduction in commissions paid to the brokers selling the offering in some circumstances.

These margins could even be lowered more if FINRA determines that non-sales related broker-dealer costs that an affiliated issuer may directly or indirectly pay also need to be paid from the 15% for offering expenses and selling compensation.

Hindrance to Small Offerings

Rule 5122 will create problems with small offerings. Offering expenses such as printing, legal, and due diligence costs will generally be a specific cost not necessarily related to the size of the offering. Small offerings, e.g. offerings of \$500,000 or under, may have problems fulfilling Rule 5122's use of proceeds requirements because of the offering expenses related to the offering. This would generally require that a greater sum be raised, even if all the funds are not immediately required for the business purpose.

Possible Causes of Action in FINRA Arbitrations

The duty that for a FINRA member or associated person to conform an control affiliate's use of proceeds to Rule 5122's standards might create a private cause of action against a broker-dealer or associated person for the misuse of funds by the issuer. Further, a violation of the use or proceeds disclosure or filing requirements may also create a cause of action for an investor outside of the anti-fraud provisions of the federal or state securities laws.

Written Supervisory Procedures

All broker-dealers authorized to conduct private offerings in their member agreement will be required to edit their written supervisory procedures to encompass the Rule 5122. The procedures should say that a senior principal or compliance officer must review each private offering to determine if it fits within the Rule 5122's control definition or any of the rule's exemptions. The procedures should also state that if such a determination is made that the firm has procedures to ensure that:

- 1) each offeree receives a private placement memorandum, term sheet or other disclosure document;

2) the private placement memorandum or other disclosure document discloses the intended use of offering proceeds and the offering expenses in the form of offering expenses and selling commissions;

3) the private placement memorandum or other disclosure document states that at least 85% of the proceeds are used for the stated business purpose in the memorandum;

4) the private placement memorandum or other disclosure document, including exhibits and amendments, is filed with FINRA's Corporate Financing Department before or at the time the private placement memorandum is provided to a prospective investor, or (in the case of amendments and exhibits) within ten days of being provided to an investor; and

5) the broker-dealer seeks such accounting records from the affiliated issuer to show that at least 85% of the offering proceeds are going to the business purpose of the offering and that the proceeds were spent consistent with the use of proceeds disclosure; and

6) the broker-dealer has steps to attempt to promptly bring a non-conforming control affiliate issuer into compliance with Rule 5122 if it learns that conditions of Rule 5122 have not been met.

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Sample compliance procedures and the text of Rule 5122 are attached.

SAMPLE COMPLIANCE PROCEDURES FOR RULE 5122

Supplemental Private Placement Procedures for Offerings by Affiliated Entities

For any private offering of securities issued by the Firm or in which the Firm directly or indirectly owns a portion of the issuer, the issuer directly or indirectly owns a portion of the Firm, or in which the issuer and the Firm have overlapping ownership, the Firm shall use the following procedures. For the purposes of these procedures, “Disclosure Documents” shall refer to private placement memoranda, term sheets, purchase agreements, letters of intent, supplemental disclosure documents and any other offering documents provided or to be provided to investors.

- 1) Before an offer is made, the Disclosure Document shall be provided to (Compliance or Legal) for review of compliance with FINRA Rule 5122.
- 2) (Compliance or Legal) shall review the Disclosure Documents to determine if:
 - a. For corporate entities such as corporations or limited liability companies: 50% or more of the equity voting rights are directly or indirectly beneficially owned by the Firm or one of its affiliates;
 - b. For non-corporate entities such as partnerships, trusts, and joint ventures: 50% or more of the distributable profits and losses are to be directly and indirectly to or by the Firm or one of its affiliates; and
 - c. If the offering is exempt from the application of FINRA Rule 5122 because it involves any of the following:
 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;
 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 NASD Rule 2710(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 FINRA Department of Corporate Financing under NASD Rules 2710, 2720 or 2810.

- 3) If (Compliance or Legal) determines that the Firm or its affiliates directly or indirectly beneficially own 50% or more of the voting equities of the corporate entity issuer or receive 50% of the distributable profits and losses of the non-corporate entity issuer and that it does not fall within one of the enumerated exemptions, then the Firm shall follow the following procedures to seek compliance with FINRA Rule 5122.
- 4) (Compliance or Legal) shall review the Disclosure Documents to determine that it discloses the intended use of offering proceeds and the offering expenses in the form of offering expenses and selling commissions. If they do not, the Firm may not participate in the Offering. If the Disclosure Documents are deemed inadequate in its intended use of offering proceeds disclosure, it may be reviewed again after corrective changes to the disclosure have been made.
- 5) (Compliance or Legal) shall review the Disclosure Documents to determine that it states that at least 85% of the offering proceeds will be used for the business purpose of the offering which shall not include offering costs, commissions, discounts, and any other cash or non-cash incentives. If they do not, the Firm may not participate in the Offering. If the Disclosure Documents are deemed inadequate in its intended use of offering proceeds disclosure, it may be reviewed again after corrective changes to the disclosure have been made.
- 6) The Firm shall file a copy of the Disclosure Documents with the FINRA Corporate Financing Department using the FINRA online filing system before or at the time of first providing the Disclosure Documents to a prospective offeree. Further, the Firm shall file copies of exhibits and amendments to the Disclosure Documents with the FINRA Corporate Financing Department within ten days of their presentation to prospective investors using the FINRA online filing system
- 7) The Firm shall seek to receive from the issuer an accounting of the use of proceeds sufficient to determine if the issuer complied with Rule 5122's requirement that at least 85% of the offering proceeds were used for the business purpose stated in the Disclosure Documents, and that the offering proceeds were spent in conformity with the disclosure of use of proceeds in the Disclosure Documents.

FINRA Rule 5122

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.