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Via E-mail: ***pubcom@finra.org***

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, D.C. 2006-1506

Re: FINRA Regulatory Notice 11-04
Regulation of Private Placements

This submission is made in response to the request for comment published by the Financial Industry Regulatory Authority, Inc. ("FINRA") in Regulatory Notice 11-04 (January 2011) regarding a proposal to expand the scope of FINRA Rule 5122 (the "Rule") to apply its filing, disclosure and restrictions on the intended use of proceeds to all private placements in which a FINRA member participates unless exempted by the Rule (the "Proposal"). Currently, the requirements of Rule 5122 are limited to private placements in which a participating FINRA member (or its control entity) is the issuer. The opportunity to comment on the Proposal is appreciated.

COMMENTS

The Term "Broker-Dealer"

The Proposal includes amendments to several provisions that would use the term "broker-dealer." When the term "broker-dealer" is used in FINRA Rule 5130, it is for the purpose of including in the category of "restricted persons" all broker-dealers regardless of whether registered as a FINRA member. Nonetheless, FINRA Rule 5130 is only applicable to the sales practices of FINRA members.

Since the Proposal does not provide an explanation of why the term "broker-dealer" is used rather than the term "member" or "FINRA member" and the explanation in the Proposal solely discusses the application of the Rule to FINRA members (not other broker-dealers), the use of the term "broker-dealer" appears to be an oversight. This is to recommend that the term be replaced, as appropriate, with the term "member," "FINRA member," or "participating member."

Definition of "Private Placement"

The current definition of "private placement" would be retained for purposes of the expansion of Rule 5122. The definition is extremely broad in extending the Rule to any "non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act." Although this sweeping definition is narrowed by the exemptions contained in Rule 5122(c), it nonetheless remains problematic because the concept of a "non-public offering" is not a defined concept under the securities laws. I am concerned that the lack of specificity in the definition of "private placement" may result in inadvertent non-compliance with the Rule as well as the unnecessary application of the Rule to offerings that do not present the investor protection concerns that FINRA intends to regulate.

FINRA is requested to consider that it would be more consistent with the broad reach of FINRA Rule 5110 and 5121 to "public offerings" as defined in Rule 5121(f)(11) to generally define "private placement" to include those types of offerings specifically excluded from the definition of "public offering" and understood to be "private placement" offerings consistent with the concepts embodied in Section 4(2) of the Securities Act of 1933 ("Securities Act"). This is to recommend that the definition of "private placement" be revised to mean "securities exempt from registration with the SEC pursuant to the provisions of Sections 4(2) or 4(6) of the Securities Act or pursuant to Rule 504 of Regulation D if the securities are 'restricted securities' under Securities Act Rule 144(a)(3), Rule 505 of Regulation D, or Rule 506 of Regulation D."[1] This definition would encompass the types of private placements (i.e., private placements pursuant to SEC Regulation D and Section 4(2) of the Securities Act) that FINRA has identified in the Proposal and in FINRA Regulation Notice 10-22 as raising investor protection concerns.[2]

Disclosure of "Compensation"

The Proposal would require in proposed Rule 5122(b)(1)(iii) that the private placement document disclose the offering expenses and the amount and type of compensation that will be paid to participating broker-dealers.[3] FINRA explains in the Proposal that the term "selling compensation" is proposed to be replaced with the term "compensation" in order to "ensure that the disclosure requirements reach the amount and type of *any* compensation that will be paid directly or indirectly to a participating member firm for its associated persons in connection with a private placement subject to the rule . . . ." As is the case with public offerings, an issuer of securities may compensate a FINRA member for different services that are not related to the private placement subject to the Rule. Therefore, this is to recommend that FINRA revise the disclosure requirement to clarify that it applies to "compensation that will be paid to participating [broker-dealers] members or associated persons in connection with the private placement . . . ."

[1] This text is from Rule 5110(b)(8)(A). *See* Rule 5121(f)(11).

[2] If FINRA includes this proposed definition of private placement in Rule 5122, the exemptions for certain types of issuers and offerings should nonetheless remain in the Rule 5122(c) in order to provide clarification as to the scope of the Rule.

[3] As previously recommended, the term "broker-dealer" should be changed to "member."

Disclosure of Affiliation - Definition of "Affiliate"

The Proposal would require in proposed Rule 5122(b)(1)(iii) that the private offering document include disclosure "if applicable, that the issuer and any participating broker-dealer[4] are affiliates and the nature of the affiliation." The Proposal would define the term "affiliate" in terms of the presence of "control." Proposed Rule 5122(a)(2) would define the term "control" by reference to the definition provided in FINRA Rule 5121(f)(6). Under the definition of "control" in Rule 5121, FINRA's rule regulating conflicts of interest in public offerings, a "control" relationship between the issuer and a participating FINRA member is deemed to exist if either "entity" (as that term is defined in Rule 5121):

> (1) beneficially owns 10% or more of the outstanding common equity, subordinated debt, or outstanding preferred equity of the other entity (including any right to receive such security within 60 days of the member's participation in the public offering);
> (2) has a right to 10% or more of the distributable profits or losses of an entity that is a partnership (including the right to receive such interest within 60 days of the member's participation in the public offering); and
> (3) has the power to direct or cause the direction of the management or policies of the other entity.

Exceptions to the Disclosure of an Affiliate Relationship: The term "affiliate" would be defined in proposed Rule 5122(b)(1) to "mean a company that controls, is controlled by or is under common control with a broker-dealer."[5] This definition in the Proposal differs from the definition of "affiliate" in Rule 5121(f)(1) in that the term "entity" is used instead of the term "company." The impact of this change is significant in that the definition of "affiliate" in proposed Rule 5122 would not exclude from the disclosure requirement offerings by four types of issuers that FINRA has previously concluded should not be subject to Rule 5121.

The definition of the term "entity" in Rule 5121(f)(7) excludes from the definitions of "affiliate," "control," and "conflict of interest" an investment company registered under the Investment Company Act of 1940 ("1940 Act", a "separate account" as defined in Section 2(a)(37) of the 1940 Act, a "real estate investment trust" as defined in Section 856 of the Internal Revenue Code, and a "direct participation program" as defined in FINRA Rule 2310. Since relationships between a participating FINRA member and the enumerated types of issuers do not trigger compliance with the disclosure and other requirements of Rule 5121 in the context of a public offering, it appears inconsistent that such relationships should require disclosure under the Proposal except to the extent required by Securities and Exchange Commission ("SEC") anti-fraud rules and regulations.

In order to clarify that the exemptions contained in the definition of "entity" in Rule 5121would also apply to the determination of an "affiliate" relationship requiring disclosure under Rule 5122, this is to recommend that FINRA revise the term "affiliate" in Rule 5122(a)(1)

[4] *Id.*

[5] *Id.*

to replace the word "company" with the word "entity" and include the following definition of the term "entity":

For purposes of this Rule, the term "entity" has the meaning specified in Rule 5121.

Scope of "Affiliation": By incorporating the definition of "control" from FINRA Rule 5121 into Rule 5122, the Proposal would extend the concept of an "affiliate" relationship to situations that investors may not generally view as creating an affiliation between an issuer and a participating FINRA member. The definition of "control" was adopted and expanded beyond the concept of "affiliate" in 2009, when FINRA significantly amended Conduct Rule 2720 of the National Association of Securities Dealers, Inc. ("NASD"), which was subsequently renumbered as FINRA Rule 5121.[6] Prior to that rule change, the definition of "affiliate" in NASD Rule 2720 was generally limited to the situations in which one entity beneficially owned 10% or more of the outstanding voting securities of the other entity which is a corporation, 10% or more of the distributable profits or losses of the other entity which is a partnership, or where there was management control. The amendments to NASD Rule 2720 extended the definition of "control" to the ownership of common equity, subordinated debt and preferred equity, which security-ownership situations were treated under that rule as a "conflict of interest" that did not result in an affiliation.

Since the Proposal would require disclosure of the relationships described under the definition of "control" in FINRA Rule 5121 as an "affiliate" relationship, I am concerned that this description may inadvertently impact the concept of "affiliate" under other SEC and FINRA rules and regulations. Moreover, the proposed requirement to disclose an "affiliate" relationship appears inconsistent with the requirements of Rule 5121(a)(1) and (a)(2) to disclose "conflicts of interest" – not "affiliations."

FINRA is requested to consider revising the Proposal to either:

1. Include a definition of "affiliate" in Rule 5122(a)(1) that would limit the term to relationships based on ownership of the voting securities, an interest in profits and losses and management control;[7] or

[6] Securities Exchange Act Release No. 60113 (June 15, 2009); 74 Fed. Reg. 29255 (June 19, 2009); Securities Exchange Act Release No. 62702 (Aug. 12, 2010); 75 Fed. Reg. 51447 (Aug. 18, 2010).

[7] This change may be accomplished by deleting the term "control" in proposed Rule 5122(a)(2) and amending the term "affiliate" in proposed Rule 5122(a)(1) as follows: "The term 'affiliate' means a company that controls, is controlled by or is under common control with a [broker-dealer] member. The term 'control' means: (i) beneficial ownership of 10 percent or more of the outstanding voting equity of an entity, including the right to receive such securities within 60 days of the member's participation in the private placement; (ii) the right to 10 percent or more of the distributable profits or losses of an entity that is a partnership, including any right to receive an interest in such distributable profits or losses within 60 days of the member's participation in the private placement; or (iii) the power to direct or cause the direction of the management or policies of an entity; except with respect to an offering by (a) an investment company registered under the Investment Company Act of 1940; (b) a "separate account" as defined in Section 2(a)(37) of the Investment Company Act of 1940; (c) a "real estate investment trust" as defined in Section 856 of the Internal Revenue Code; and (d) a "direct participation program" as defined in Rule 2310." Since the exemptions contained in the definition of "entity" in Rule 5121 would be included in the proposed definition of "affiliate" in Rule 5122, the recommendation set forth above to change the term "company" to "entity" would be moot.

2. If FINRA determines to retain the broader definition of "control" provided in Rule 5121, amend the Proposal to require disclosure of a "control relationship" in place of the term "affiliate."[8]

Use of Offering Proceeds

Payment of "Other Compensation": FINRA proposes to revise Rule 5122(b)(3), the provision regulating the use of offering proceeds, to replace the requirement that at least 85% of the offering proceeds may not be used (among other things) to pay for "commissions, or any other cash or non-cash sales incentives" with a requirement that the proceeds may not be used to pay for "commissions, and any other compensation to participating broker-dealers or associated persons . . . ."[9] In some cases, private placements are for the purpose of raising proceeds for business purposes that may result in the payment of other fees to a FINRA member that has participated in the private placement. For example, the issuer may conduct a private placement to raise proceeds for an acquisition and a participating member may subsequently be paid a fee for arranging the acquisition transaction. The use of the private placement proceeds for this purpose, which is unrelated to the distribution of the private placement, would be required to be disclosed in the private placement document pursuant to Rule 5122(b)(1)(A) and should not be required to be included in the calculation of the compensation paid to participating members in connection with the private placement.

Consistent with the recommendation set forth above regarding disclosure of the compensation paid to participating members, this is to recommend that FINRA revise proposed Rule 5122(b)(3) to require that at least 85% of the offering proceeds may not be used (among other things) to pay for "commissions, and any other compensation that is paid to participating [broker-dealers] members or associated persons in connection with the private placement . . . ."

Clarification That Rule 5122(b)(3) Applies Only to the Use of Proceeds: This is also to request that FINRA clarify in its rule filing with the SEC or in supplementary material to the revised Rule that Rule 5122(b)(3) only regulates the use of the private placement proceeds and does not prevent an issuer from paying any form of compensation to a FINRA member participating in the private placement from sources other than the private placement proceeds. This position would be the same as that set forth in FINRA Rule 2310 with respect to the 15% limitation on organization and offering expenses, which only applies to payments from the offering proceeds. Thus, if an issuer pays a commission, expense reimbursement or a trail commission from the company's operating revenues or retained earnings, or pays compensation in the form of securities or warrants for securities to the participating FINRA member(s), FINRA should clarify that the value of such items of compensation will not be deemed to be included in the calculation under Rule 5122(b)(3) for purposes of compliance with the 85% standard. It should be noted that, nonetheless, Rule 5122(b)(1)(A)(ii) would require the disclosure of all

[8] This change may be accomplished by deleting the term "affiliate" in proposed Rule 5122(a)(1) and amending proposed Rule 5122(b)(1)(iii) as follows: "if applicable, that the issuer and any participating broker-dealer [are affiliates] has a control relationship and the nature of the [affiliation] control relationship."

[9] As previously recommended, the term "broker-dealer" should be changed to "member."

items and amount of compensation that will be paid to any participating member in connection with the private placement regardless of whether such items of compensation are paid from the private placement proceeds.

Application of the 85% Standard to Smaller Offerings: The current version of Rule 5122(b)(3) and the Proposal provide that at least 85% of the offering proceeds raised may not be used to pay for offering costs, discounts, commissions and any other compensation to participating FINRA members, and must be used for the business purposes disclosed in the offering document.[10] FINRA requested comment as to whether this requirement would impose an unnecessary burden on smaller private placements.

While the 85% standard may have been appropriate for a "member private offering" of any size under the current Rule as a result of the affiliate relationship between the issuer and the placement agent-FINRA member, there may be higher offering expenses in the case of private placements by FINRA members independent of the issuer that could disproportionately impact smaller private placements. This difference is recognized in FINRA Rule 2310, which only limits such total organization and offering expenses (composed of both underwriting compensation and issuer-only expenses) to 15% of the offering proceeds in the case of offerings of direct participation programs and real estate investment trusts in which a member affiliated with the issuer participates in the offering. The FINRA underwriting compensation limitations have long taken into account the smaller size of an offering by allowing a higher percentage of underwriting compensation than is permitted in larger offerings.[11] If such higher percentages of underwriting compensation are permitted in smaller public offerings, then the percentage limitation on the use of offering proceeds in the Rule should also take into account the proportionally higher underwriting compensation and issuer and FINRA member expenses that may be present in the case of smaller private placements.

This is to recommend that FINRA modify the Proposal to address smaller private offerings by amending proposed Rule 5122(b)(3) as follows:

> For each private placement, at least 85% of the offering proceeds raised (75% in the case of offering proceeds of less than $15 million) . . . .

The 75% standard was developed by estimating that the FINRA member(s) acting as placement agent(s) may receive a 10% commission on sales, plus an expense reimbursement of up to 2% of offering proceeds. For an offering of less than $15 million, the remaining 3% under the 85% standard may be insufficient to cover the issuer's accounting, legal, printing and other

[10] The proposed amendments to this provision should be revised, as previously recommended, to change the term "broker-dealers" to "members."

[11] As stated in NASD Notice to Members 92-53 (1992), "The maximum [compensation] guideline amount generally will vary directly with the amount of risk assumed by the underwriter and inversely with the dollar amount of offering proceeds." This notice included a table of "generally accepted levels of underwriting compensation" that was based on FINRA's actual experience with respect to some 874 public offerings reviewed by the FINRA Corporate Financing Department. *See*, FINRA Rule 5110(c)(2)(D).

offering expenses. FINRA may wish to consider that it is more important that there be a limitation on the use of offering proceeds that ensures that the majority of the offering proceeds are used for the disclosed purposes than for FINRA Rule 51222 to inadvertently restrict the ability of issuers to raise capital in smaller private placements.

Exemptions from the Rule

Clarification of Reliance on Multiple Exemptions: The current version of Rule 5122 and the Proposal exempt from the Rule offerings sold to a number of categories of investors and by a number of types of issuers and offerings of certain types of securities, which are set forth in Rule 5122(c)(1) – (13) (as proposed to be revised). Although the introduction to Rule 5122(c)(1) states that the exemptions under that provision are available only if sales are made "solely" to the five types of institutional investors enumerated in that provision, FINRA clarified in Regulatory Notice 09-27 (May 2009) that "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." This is to recommend that FINRA adopt supplementary material to Rule 5122 that sets forth this explanation.

De Minimis Participation by Accredited Investors: The current version of Rule 5122 and the Proposal would not exempt a private placement from the requirements of the Rule that is sold to any investor that would solely meet the SEC's "accredited investor" standard under Rule 501(a) of SEC Regulation D, even though the rest of the offering may be sold to the categories of investors meeting the more stringent investor qualification standards set forth in Rule 5122(c)(1)(A) – (F) (together, the "Exemptions"). The Exemptions are only available if sales are made to institutional accounts, qualified purchasers, qualified institutional buyers, investment companies or banks. When an issuer offers private placement securities to the kind of institutional accounts set forth in the Exemptions, it is not unusual that the issuer and participating FINRA members find that a *de minimis* amount of offering proceeds must be raised from institutional-type accounts (*i.e.*, generally not individuals) that, however, do not meet the standards of the Exemptions in order to successfully complete the sale of the entire private placement.

This is to request that FINRA consider that sales of the major part of a private placement to investors meeting the stringent institutional investor standards of the Exemptions should protect any accredited investor participating in the private placement and obviate the need for FINRA oversight of offering disclosure and the issuer's use of proceeds. The institutional investors covered by the Exemptions have the financial sophistication and resources to negotiate the terms of the securities with the issuer, understand the terms of the offering and conduct due diligence with respect to the issuer and the offering independent of any FINRA member participating in the offering, as well as the financial clout to obtain additional information and documents from the issuer upon request. This is to recommend that FINRA amend the Proposal to adopt an additional exemption for sales of a *de minimis* amount of shares in a private

placement to accredited investors so long as the major part of the shares are sold to investors meeting any of the Exemptions by adopting new Rule 5122(c)(2) to exempt:

> offerings in which at least 75% of the securities that are sold are purchased by investors that meet any of the exemptions under subparagraph (c)(1) and the remaining amount of the securities that are sold are purchased by investors that meet the definition of "accredited investor" in SEC Rule 501(a) of Regulation D.

The use of the phrase "securities that are sold" is intended to clarify that the calculation is based on securities sold rather than on the number of securities offered in the private placement. Consistent with the recommendation set forth above, FINRA should also add supplementary material to the Rule clarifying that the proposed *de minimis* exemption may be combined with any other exemption. For example, if at least 75% of the securities sold are purchased by investors covered by the Exemptions, the remaining shares may be purchased by accredited investors and also by employees or affiliates of the issuer. The supplementary material should also clarify that to the extent that no sales are made to accredited investors, the 75% limitation would not apply to other situations in which there is reliance on more than one exemption from the Rule.

Exemption for Offerings Filed with the FINRA Corporate Financing Department: Rule 5122(c)(13) (as proposed to be renumbered) exempts offerings filed with the FINRA Corporate Financing Department under FINRA Rule 2310, 5110 or Rule 5121, but not the offerings that can rely on an exemption from filing (but which remain subject to the substantive requirements of those rules) under FINRA Rule 5110(b)(7). This is to recommend that FINRA amend the exemption in Rule 5122(c)(13) to apply to "offerings subject to compliance with FINRA Rule 2310, 5110 or Rule 5121."

* * *

I hope that these comments will be helpful to FINRA in its consideration of the Proposal. I would be pleased to discuss any aspect of these comments with FINRA staff. Questions may be directed to the undersigned at 703-255-6273.

Respectfully submitted,

Suzanne Rothwell

Suzanne Rothwell
Managing Member