New York State Bar Association
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Business Law Section
Securities Regulation Committee

March 28, 2011

VIA ELECTRONIC MAIL

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
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E-mail address: pubcom@finra.org

Re: FINRA Regulatory Notice 11-04 (January 2011) – Proposed Amendments to FINRA Rule 5122 to Address Member Firm Participation in Private Placements (hereinafter, the "Notice")

Dear Ms. Asquith:

The Securities Regulation Committee of the Business Law Section of the New York State Bar Association (the "NYSBA Committee") is pleased to have the opportunity to comment on the Proposed Amendments to FINRA Rule 5122 to Address Member Firm Participating in Private Placements (the "Proposed Rule Amendments").

The NYSBA Committee is composed of members of the New York State Bar Association, a principal part of whose practice is in securities regulation. The NYSBA Committee includes lawyers in private practice and corporation law departments. A draft of this letter was reviewed by certain members of the NYSBA Committee. The views expressed in this letter are generally consistent with those of the majority of members who reviewed and commented on the letter in draft form. The views set forth in this letter, however, do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association, or its Business Law Section.

Our Overall Perspective

FINRA Rule 5122 expands authority over smaller non-institutional private placements. We are concerned about interference with the smaller private placement market, especially at a time when capital formation is so difficult. Substantive disclosure reviews of offering materials and regulation of offering costs in all private placements is a huge shift in regulatory oversight and will have a chilling effect on a capital market essential to the United States economy.

Most private placements where a broker-dealer participates fall within the scope of regulation by the United States Securities and Exchange Commission (SEC) under the federal securities laws and by statutes under state securities laws. The SEC adopted Regulation D (or Reg. D) (17 C.F.R. §230.501 *et. seq.)* in recognition of the need to properly balance the protection of investors with the capital needs of companies. To comply with Reg. D, a company must file a Form D which is a document that requires the disclosure of sales commissions and discounts; such filing is public information and will be accessible to investors. In addition, if non-accredited investors are solicited disclosure documents must be prepared and delivered to prospective investors, which materials include use of proceeds disclosure. By utilizing Reg D, companies are able to offer and sell their securities without having to go through the potentially more complicated, expensive and lengthy process of registering the offer and sale of the securities with the SEC.

Reg. D offerings have provided a whole segment of companies in the U.S. economy with the ability to gain access to capital markets that they could not otherwise have access to because they could not bear the costs of a normal SEC registration. Among small and growing business, these offerings have become the most common cost-and time-saving method to raise capital from private investors. We believe that the Proposed Rule Amendments would regulate an area already within the regulatory scope of the SEC and all fifty states. The Proposed Rule Amendments would hamper a company's ability to fundraise easily by regulating offering fees and implementing substantive review of offering documents with ill defined parameters. Such regulation and review would provide disincentives for member firms and their issuer clients who participate in raising private capital in critical markets where participants cannot afford additional costs and regulatory burdens.

Lastly, most Reg. D offering investors are "accredited investors" as defined under Reg. D or are considered sophisticated—"that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment."[1] These private investors provide a great deal of capital to issuers and have been deemed by the SEC to be capable of making investment decisions and not in need of protection. The Congress as most recently as last summer revisited Reg. D offerings when The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), was signed into law on July 21, 2010. The Act required the SEC to make a change to the net worth test contained in the definition of "accredited investor" that is applicable to all offerings exempt under Reg. D (especially Rule 506). By requiring this change Congress acknowledged that investors needed more protection and that they could accomplish this by requiring that net worth be calculated with a higher standard. If Congress believed, especially after this last financial crisis, that additional regulation should be implemented in order protect investors then it would have included such changes in the Act. Offerings in reliance of Reg. D, particularly ones that are relying on Rule 506 should be exempt from the scope of Rule 5122.

<u>Disclosure Requirements</u>

As mentioned above, the Form D filing made by companies upon the completion of a private placement requires the listing of any broker-dealers involved in the offering and the fees paid to them. In addition, if disclosure documents are required under Reg D, they must provide disclosure of offering costs and use of proceeds to investors. The Proposed Rule Amendments would thus require duplicative disclosure or disclosure already deemed by the SEC as not required. We agree with FINRA's goal to protect investors from misuse of offering proceeds but we believe that investors are protected and given proper disclosure through Reg. D.

<u>Filing Requirements/Substantive Review</u>

The SEC and most states do not perform a substantive review of the disclosure made in private placements; therefore, companies are able to raise money more efficiently and quickly. Adding a filing and substantive review period for offering materials in private placements, as provided in the Proposed Rule Amendments, will have a chilling effect on a company's ability to raise money and will prevent the closing of a transaction from happening quickly. We appreciate FINRA's view that "the Proposed Rule does not require that completion of an offering be delayed

[1] See http://www.sec.gov/answers/rule506.htm

until FINRA staff has issued a "no-objections" letter, as FINRA Rule 5110 requires with respect to public offerings;"[2] however, we believe that companies and broker-dealers will be reluctant to do so because of the potential implications of any comments. If any comments are received after a closing it is impractical to update disclosure because investors have already made their decision to invest after reviewing the disclosure initially provided. Updating disclosure for material disclosure comments could require issuers to give investors the right to rescind their investments. If updating of material comments is not made, such comments could be used by investors to claim that there had been a material misstatement or omission and to seek damages for Rule 10b-5 liability. Even if a company updates the disclosure after receiving comments from FINRA a company could still be subject to investors seeking to withdraw or rescind because making an investment in such an environment could have a chilling effect on an investor. Reinvestment probably is doubtful even after an "all clear". While possible that investors might seek to invest even without a "no-objections" letter (and together with the company, hope for the best), another conclusion might be that investors choose to avoid the possibility that they may be seeking an early withdrawal, and decline to make any investment altogether. All these uncertainties could impede unnecessarily the ability to raise capital quickly at times when companies may be most in need of financing.

The Proposed Rule Amendments also do not provide a clear timeframe as to when FINRA will provide comments, if any, to a member firm regarding the required disclosure. A clear timeframe for the receipt of comments, if any, is necessary because, as mentioned above, member firms, issuers and investors will not agree to closing transactions if comments on material disclosure may occur at any time post closing.

Cap on Offering Costs and Compensation

The Proposed Rule Amendments also proposes to limit the amount of offering proceeds that can be used to pay for offering costs, discounts, commissions or any other compensation to participating broker-dealers. Historically such fees have not been regulated and private capital markets have been allowed to operate freely. We appreciate FINRA's goal of ensuring that the money provided by investors be used for the purposes disclosed to investors but we believe that the disclosure requirements of Reg. D address this concern. FINRA's belief that no more than 15% of

[2] See Notice at page 3.

the money raised be used to pay for offering costs and compensation is assumedly intended to provide protection for investors and issuers but may well harm such parties by decreasing access to capital markets. Capping offering costs and compensation will make it more difficult for some companies to gain access to the capital markets and hire quality service providers as well. It might also have the effect of having companies pursue areas of financing of dubious legality.

When companies pursue a private placement, often they are either small or growing and in great need of capital or they are established private or public companies that may be having difficulty raising money and find that a private placement is the only way to raise capital. In many circumstances, the higher costs of capital (i.e. higher commissions or discounts) are the only way to get a broker-dealer or a service provider to agree to take on the task of finding money and providing services for companies having difficulty raising capital. In other cases where an offering is small, offering costs may well be above the 15% of the total raise because the costs required for material disclosure and fees for a smaller offering are generally comparable to those for a larger offering. Capping fees will effectively shut off access to capital markets and hinder the success of many companies. Moreover, FINRA has not provided support as to why the 15% threshold makes sense in all circumstances especially when the 15% threshold is often exceeded in many small public company offerings.

The Proposed Rule Amendments are also unclear as to whose offering costs, discounts and commissions are included in the 15% fee cap. For example, would the cost of a company's attorney and accountants be included in the fee cap or does it only include the costs of the broker-dealer? If the Proposed Rule Amendments are adopted then the rule must clearly define whose fees are included in the disclosure so broker-dealers and their clients are confident they are providing the required information. If FINRA's intention is to require disclosure of all the compensation involved in a private placement then a significant burden will be placed on the broker-dealer because it would need to ascertain all of the compensation involved in the transaction and that could be difficult to accomplish and even more challenging to police. Indeed the Proposed Rule Amendments might even seem to be a regulation of issuers which would appear to go beyond the jurisdiction of FINRA as provided in Section 15A of the Securities Exchange Act of 1934.

Unintended Consequences

The Proposed Rule Amendments incorporate the definition of the term "participation" from FINRA Rule 5110(a)(5). Such definition is quite broad and provides, among many other things that a broker-dealer is participating when it is providing services "in any advisory or consulting capacity". By including such broad language it is unclear if Rule 5122, as proposed to be amended, would apply to non-equity raising transactions such as mergers and acquisition deals where the parties are sophisticated entities who do not need the type of protection FINRA is concerned with providing. The Proposed Rule Amendments need to clearly exclude transactions that do not primarily involve the raising of capital.

In sum, we are concerned that, the Proposed Rule Amendments will be duplicative of existing requirements in some cases and in others unnecessarily interfere with a company's ability to raise capital through private placements and that such interference will prevent innovation and will hurt the U.S. economy.

We are grateful for the opportunity to provide these comments and for FINRA's attention and consideration.

Respectfully submitted,

SECURITIES REGULATION COMMITTEE

/s/ Howard B. Dicker
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Chair of the NYSBA Committee

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