Financial Industry Regulatory Authority

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January 19, 2012

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-FINRA-2011-057 – Response to Comments

Dear Ms. Murphy:

This letter responds to comments submitted to the Securities and Exchange Commission ("SEC" or "Commission") regarding the above-referenced rule filing, a proposed rule change to adopt new FINRA Rule 5123 (Private Placements of Securities) ("Proposed Rule").

The Proposed Rule would require members that offer or sell certain private placements, or participate in the preparation of disclosure documents in connection with such private placements, to provide disclosures to each investor prior to sale describing the anticipated use of offering proceeds, and the amount and type of offering expenses and offering compensation. The Proposed Rule would also require a FINRA member to make an "notice filing" of the disclosure document with FINRA no later than 15 days after the first sale, and to file material amendments to the disclosure documents no later than 15 days after they are provided to any investor or prospective investor. The Proposed Rule is designed to provide both investors and FINRA with information about private placements.

The Commission received fifteen comment letters in response to the Proposed Rule.[1] While many expressed support for the goals of the proposal,[2] the commenters

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1 See Letters from Ryan Adams, Christine Lazaro, Esq., and Lisa Catalano, Esq., St. John's School of Law Securities Arbitration Clinic, to Elizabeth M. Murphy, Secretary, SEC, dated November 10, 2011 ("St. John's"); Ryan K. Bakhtiari, President, Public Investors Arbitration Bar Association, to Elizabeth M. Murphy, Secretary, SEC, dated November 14, 2011 ("PIABA"); David T. Bellaire, Esq., Financial Services Institute, Inc., to Elizabeth M. Murphy, Secretary, SEC, dated November 14, 2011 ("FSI"); Robert E. Buckholz, Chair, Committee on Securities Regulation, New York City Bar Association, to

expressed a range of concerns. Concerns touched upon the following broad issues regarding the Proposed Rule: its scope, as dictated by the definition of private placement; disclosure requirements; filing requirements; and exemptions. Based on these comments, FINRA is proposing to make certain modifications to the Proposed Rule. Below is a discussion of the comments, together with FINRA's responses thereto.

Scope and Definition of Private Placement

The Proposed Rule describes a private placement as any security offered or sold by a member or associated person "in reliance on an available exemption from registration under the Securities Act."[3] Several commenters raised concerns that this definition of private placement is overbroad.[4] For example, commenters argued that,

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Elizabeth M. Murphy, Secretary, SEC, dated November 9, 2011 ("NYC Bar"); Richard B. Chess, President, Real Estate Investment Securities Association, November 14, 2011 ("REISA"); Martel Day, Chairman, Investment Program Association, to Elizabeth M. Murphy, Secretary, SEC, dated November 14, 2011 ("IPA"); Jack E. Herstein, President, North American Securities Administrators Association, Inc., to Elizabeth M. Murphy, Secretary, SEC, dated November 17, 2011 ("NASAA"); Joan Hinchman, Executive Director, National Society of Compliance Professionals, to Elizabeth M. Murphy, Secretary, SEC, dated November 14, 2011 ("NSCP"); William A. Jacobson, Associate Clinical Professor, and Carolyn L. Nguyen, Cornell Law School, to Elizabeth M. Murphy, Secretary, SEC, dated November 14, 2011 ("Cornell"); Stuart J. Kaswell, Executive Vice President, Managed Funds Association, to Elizabeth M. Murphy, Secretary, SEC, dated November 14, 2011 ("MFA"); William H. Navin, Senior Vice President, The Options Clearing Corporation, to Elizabeth M. Murphy, Secretary, SEC, dated November 9, 2011 ("OCC"); Jeffrey W. Rubin, Chair, Federal Regulation of Securities Committee, American Bar Association, to Elizabeth M. Murphy, Secretary, SEC, dated November 14, 2011 ("ABA"); Sullivan & Cromwell LLP, to Elizabeth M. Murphy, Secretary, SEC, dated November 10, 2011 ("S&C"); Osamu Watanabe, Deputy General Counsel, Moelis & Co., to Elizabeth M. Murphy, Secretary, SEC, dated November 28, 2011 ("Moelis"); and Donald S. Weiss, K&L Gates LLP, to Elizabeth M. Murphy, Secretary, SEC, dated November 14, 2011 ("K&L Gates").

[2] Cornell; FSI; NASAA; PIABA; St. Johns.

[3] See proposed Rule 5123(a).

[4] ABA; NYC Bar; S&C. See also NASAA (seeking clarification as to the application of the Proposed Rule to secondary transactions of private placements).

ostensibly due to the fact that it is not expressly limited to "non-public" offerings, this definition was much broader than the definition of "private placement" in Rule 5122 (Private Placements of Securities Issued by Members), which applies to member private offerings.[5]

Commenters asserted that, as currently drafted, the Proposed Rule could be interpreted to apply to any offer or sale of securities for which an exemption from registration is claimed under the Securities Act, including public offerings and secondary market trading. They suggested explicitly narrowing the scope of Rule 5123 to specific types of "non-public" offerings, or referring back to the definition of "private placement" in Rule 5122. The ABA asserted that the concept of a "non-public offering" is well understood to mean a primary offering of securities that is exempt from registration under the Securities Act by reason of Section 4(2) thereof and the rules of the Commission thereunder (including Rule 506 of Regulation D).The NYC Bar asserted that exemptions pursuant to Sections 3(b), 4(2) and 4(5) of the Securities Act are traditionally viewed as being "private placement exemptions."

Based on these comments, FINRA proposes to clarify that the term "private placement" in the Proposed Rule means a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act. Accordingly, the Proposed Rule's private placement definition would be consistent with Rule 5122 and would not apply to securities offered pursuant to the following provisions:

- Securities Act Sections 4(1), 4(3) and 4(4) (which generally exempt secondary transactions);
- Securities Act Sections 3(a)(2) (offerings by banks), 3(a)(9) (exchange transactions with an existing holder, where no one is paid to solicit the exchange), 3(a)(10) (securities subject to a fairness hearing), or 3(a)(12) (securities issued by a bank or bank holding company pursuant to reorganization or similar transactions); or
- Section 1145 of the Bankruptcy Code (securities issued in a court-approved reorganization plan that are not otherwise entitled to the exemption from registration afforded by Securities Act Section 3(a)(10)).[6]

FINRA believes this modification will provide clarity regarding the scope of the Proposed Rule and address commenters' concerns regarding its breadth.

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[5] Rule 5122(a)(4) defines "private placement" as a "non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act" (emphasis added).

[6] See NYC Bar, S&C (advocating that the Proposed Rule not apply to the categories specified above). See also discussion supra regarding exemptions.

Disclosure Requirements

Paragraph (a)(1) of the Proposed Rule requires each member to provide applicable disclosure documentation to each investor in a private placement prior to sale. Several commenters suggested that the disclosure requirement could be interpreted to require a FINRA member to have primary responsibility for preparing disclosure documents in the event that an issuer does not prepare them.[7] Two commenters suggested that in some cases members may not have access to all necessary information from issuers[8] and one of these further asserted that it may be impractical and inefficient for members to be charged with gathering and providing the required information.[9] One commenter suggested that the production of a disclosure document by a FINRA member would increase the liability of the FINRA member in the offering.[10] Another suggested as an alternative that the Proposed Rule prohibit a member from participating in a private placement if the issuer fails to produce the mandated disclosure.[11]

REISA noted that it recommends as a best practice for Regulation D offerings the preparation of a PPM that provides full and fair disclosure of material aspects of the offering. FINRA understands the common industry practice is to provide an offering document to investors in such offerings. However, REISA expressed concern that if the FINRA member is "forced to create a disclosure document" it would be an unfair burden and increase members' liabilities in private placements. As a result of these concerns, FINRA proposes to amend the Proposed Rule to eliminate the requirement that members provide investors with the required disclosures if no disclosure document is used in connection with the sale of the private placement. As described below, members participating in a private placement in which no offering document is used would still be required to make a notice filing with FINRA that identifies the offering. However, if a member uses a disclosure document, it must have all the required disclosures; members may not use a disclosure document that fails to include such basic items as the anticipated use of offering proceeds, the amount and type of offering expenses, and the amount and type of compensation provided or to be provided to sponsors, finders, consultants, and members and their associated persons in connection with the offering.

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[7] ABA; NSCP; NYC Bar; REISA.

[8] ABA; NYC Bar.

[9] ABA.

[10] REISA.

[11] NYC Bar.

One commenter misunderstood the Proposed Rule to require all selling group members to cross-deliver to all offerees.[12] It suggested that, to avoid the cost and potential for duplicative information to an investor that could result if all FINRA members in a selling group were required to provide an offering document to an offeree, that only the FINRA member that has the relationship with the offeree be required to provide the offering document. FINRA agrees with this approach and will add supplementary material to clarify the Proposed Rule's delivery requirements accordingly. Each member should only be concerned that, to the extent that disclosures are required, such disclosures are made to the customers of the firm to whom it sells the private placement.

Cornell urged FINRA to adopt a provision in the Proposed Rule to require a member to disclose any affiliation between the issuer and the member. To the extent that they are required, the disclosures in the Proposed Rule are very narrowly tailored to focus on the money raised and how it is spent in order to generate a return on investment. FINRA notes that Rule 5122 applies separately to private placements in which a member is affiliated with the issuer.

The Proposed Rule applies to members that participate in private placements. The ABA requested that FINRA provide explicit clarification regarding the term "participate." It advocated that the Proposed Rule's requirements should not apply to members that merely provide advisory, consulting or administrative services for an issuer, or in connection with a private placement, but are not otherwise making any offer or executing any sale of securities in respect of such private placement. FINRA agrees, and notes that the Proposed Rule would not apply to members merely providing advisory, consulting or administrative services for an issuer, or in connection with a private placement. This concept of "participation" is consistent with that of Rule 5121 (Public Offerings of Securities with Conflicts of Interest) rather than Rule 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements).

For private placements in which a disclosure document is used by a member, Rule 5123(a) would require, among other things, disclosure of the amount and type of compensation provided or to be provided to sponsors, finders, consultants and members and their associated persons in connection with the offering. The ABA urged FINRA to define or provide further guidance as to the scope of the terms "sponsors", "finders", and "consultants." It inquired specifically as to whether consultants would include contractors whose engagement is related to the offering or its anticipated use of proceeds, or all contractors then engaged, or anticipated to be engaged, by the issuer. FINRA believes the terms sponsors, finders and consultants are well understood by industry participants, and that, by its plain meaning, the scope of the requirement is based on whether a sponsor, finder, consultant or other person is compensated, or will be compensated, in connection with the offering. Thus,

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[12] NYC Bar.

consultants would include only those contractors that would be compensated in connection with the offering (which would include those whose engagement is related to the offering or its anticipated use of proceeds). FINRA also agrees, as one commenter stated, that disclosure by a member pursuant to the Proposed Rule does not replace or supplant the requirement for finders or consultants to comply with any other applicable FINRA rules, as well as federal or state securities laws, rules and regulations, including licensing requirements.[13]

Two commenters suggested that, because the Proposed Rule would require that members provide disclosures regarding private placements, it would circumvent or somehow be contrary to the intent of Congress and/or the federal securities laws which do not prescribe a disclosure provision for many types of private placements.[14] Similar arguments were raised in connection with the proposal and adoption of Rule 5122. FINRA does not believe the Proposed Rule, which initially was proposed as an amendment to Rule 5122, raises any new concerns to justify these comments. FINRA's rules, and those of any self-regulatory organization, frequently go beyond the requirements in the federal securities laws. This may be especially true for rules like the Proposed Rule that are promulgated in response to widespread, abusive industry practices. For example, Rule 2711 (Research Analysts and Research Reports) imposes disclosure requirements designed to protect investors that go well beyond the disclosure requirements in the Securities Act of 1933 or Securities Exchange Act of 1934. Nevertheless, as revised, the Proposed Rule does not require that the disclosures be provided to investors in sales in which no private placement memorandum, term sheet or other disclosure document is used. Thus, the Proposed Rule will not impose a requirement to create a disclosure document in circumstances where no disclosure is required under the federal securities laws. This change should remove any implication that the Proposed Rule will be an unnecessary burden on capital formation. As a practical matter, private placements of the type covered by the Proposed Rule, that are sold to the investors covered by the Proposed Rule, should in nearly every case have a disclosure document; private placements for which there is no disclosure document are likely to raise red flags as part of a member's suitability obligations. However in those limited instances where a disclosure document appropriately does not exist, the Proposed Rule will not impose an obligation to create one.

Three commenters alleged that the Proposed Rule could significantly affect the ability of many issuers to raise capital.[15] The ABA and MFA further concluded that the Proposed Rule is therefore inconsistent with Section 3(f) of the Exchange Act

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13 NASAA.

14 ABA; MFA.

15 ABA; MFA; REISA.

because it is inconsistent with the framework that Congress established for raising capital in private placements. Section 3(f) of the Exchange Act requires the Commission, as part of its review of a rule of a self-regulatory organization, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation. MFA asserted that by requiring a FINRA member that offers or sells private placements to provide disclosures to each investor prior to sale, the Proposed Rule would make private offerings more costly and less efficient, thereby imposing an unnecessary burden on capital formation. FINRA disagrees. However, as noted above, FINRA has removed the requirement for a member to use a disclosure document. On the other hand, if a disclosure document is used, FINRA believes that the items required in the Proposed Rule must be included in the document, and has not received any comments that including such basic disclosures – to the extent they do not already exist – would be an unnecessary burden on capital formation.

MFA and ABA asserted that the Proposed Rule is inconsistent with Section 15A(b)(6) of the Exchange Act which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.[16] FINRA find no basis in this challenge. As noted in the rule filing, FINRA believes that the Proposed Rule is consistent with the provisions of Section 15A(b)(6) of the Securities Exchange Act in that it will provide important investor protections in connection with private placements of securities and is in the public interest. By its terms, it would apply not to issuers, but to FINRA members and their associated persons in connection with the sale of a specific type of securities, private placements, as defined in the Proposed Rule (as amended). Further, it would not prohibit members from participating in those private placements in which investors are not provided with disclosure documents; rather, as described below, members participating in such private placements would simply be required to make a notice filing with FINRA that identifies the private placement.

NASD Rule 2310, governing members' suitability obligations, requires members to conduct a robust and thorough suitability analysis before recommending

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16 MFA also asserted that the Proposed Rule is inconsistent with Section 19(b)(1)(C) of the Exchange Act. FINRA assumes from the textual description that MFA meant to refer to Section 19(b)(2)(c), Standards for Approval and Disapproval. This provision provides in part that the Commission shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations issued under the Exchange Act that are applicable to the self-regulatory organization. As described in the proposed rule change and above, FINRA believes the Proposed Rule to meet this standard.

securities in a private placement. This analysis requires a reasonable investigation into the offering and an understanding of its features, including the fees and expenses and the use of proceeds.[17] In Regulatory Notice 10-22 (April 2010), FINRA described specific issues relating to the scope of members' responsibilities to conduct a reasonable investigation of the issuer in a private placement under the suitability rule, supervisor responsibilities under NASD Rule 3010 and recordkeeping requirements. Regulatory Notice 10-22 provides that a member's reasonable investigation must be tailored to each Regulation D offering in a manner that best ensures that it meets its regulatory responsibilities and sets out lists of best practices in investigations focusing on the issuer and its managements, the issuer's business prospects and the issuer's assets. In offerings in which a disclosure document is used, requiring a disclosure document to include the information that the member already is required to obtain is a minimal additional responsibility, particularly compared to the totality of a member's suitability responsibilities.

Moreover, FINRA believes, to the extent that offering documents are used in a private placement, ensuring retail investors are provided certain minimum disclosures, coupled with FINRA's regularized and more timely review aided by the notice filing requirement, will help legitimate issuers access capital in the private placement market. The private placement market has been damaged by widespread fraud and abuse in recent years. For example, the SEC has many pending investigations regarding this subject matter[18] and has recently settled cases involving fraud or abuse in the private placement market.[19]

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17 See Regulatory Notice 10-22 (April 2010).

18 See, e.g., SEC v. Gross, Case No. 08-81039, 2008 SEC LEXIS 2116 (September 22, 2008) (SEC complaint against a registered representative of Axiom Capital Management who recommended unsuitable private placement securities to customers that were elderly, retired with limited income and risk averse); SEC v. Slowey, SEC Litigation Release No. 21258, 2009 SEC LEXIS 3459 (October 22, 2009) (SEC alleges that, regarding four real estate funds raising approximately $12 million that were sold to unsophisticated retirees and senior citizens, defendants made misrepresentations and misappropriated investor funds, and broker-dealer failed to conduct sufficient due diligence); SEC v. Constantin, SEC Litigation Release No. 22030, 2011 SEC LEXIS 2330 (July 7, 2011) (SEC alleges that, in a private placement raising $1.25 million, broker-dealer and principal made false claims regarding intended use of investor funds, broker-dealer's investment expertise, and historical returns, and misappropriated funds and provided false assurances to investors); SEC v. Rubin, SEC Litigation Release No. 22102, 2011 SEC LEXIS 3308 (September 23, 2011) (SEC alleges that former broker-dealer and principals engaged in market manipulation scheme that brought companies public through reverse mergers, raised funds through private placements, and allowed principals to sell holding at inflated prices); and SEC v. Byers, SEC Litigation Release No.

20697, 2008 SEC LEXIS 1969 (August 29, 2008) (SEC alleges that defendants engaged in a Ponzi-like scheme and raised $255 million and diverted $100 million to unauthorized purposes). SEC v. AIC, Inc., SEC Litigation Release No. 21934, 2011 SEC LEXIS 1367 (April 18, 2011) (SEC alleges an offering fraud and Ponzi scheme in connection with an offer and sale of $7.7 million notes and stock).

19 See, e.g., In Re Glenn M. Barikmo, SEC Initial Decision Release No. 436, 2011 SEC LEXIS 3573 (October 13, 2011) (SEC found that Barikmo participated in the misappropriation of funds in connection with a private placement); In Re David v. Siegel, Exchange Act Release No. 62803, 2010 SEC LEXIS 2846 (August 31, 2010) and In Re Axiom Capital Management, Inc., Exchange Act Release No. 61563, 2010 SEC LEXIS 1012 (February 22, 2010) (SEC found Siegel and Axiom failed to supervise unsuitable sales of private placements made by registered representatives to customers that were elderly, retired with limited income and risk averse); In Re Capital Financial Services, Exchange Act Release No. 64218, 2011 SEC LEXIS 1285 (April 6, 2011) (SEC found that Capital Financial Services failed to conduct a reasonable investigation and perform adequate due diligence in connection with the sale of Provident Royalties private placement securities); In Re Mortgages Ltd. Securities, LLC, Exchange Act Release No. 61377, 2010 SEC LEXIS 490 (January 19, 2010) (MLS sold private placements to thousands of investors while failing to disclose material information and concealing facts related to loan defaults); In Re MMR Investments Bankers, LLC, Exchange Act Release No. 64622, 2011 SEC LEXIS 1963 (June 8, 2011) (SEC found MMR and its associated persons sold private placement debenture offerings that defaulted, were unsuitable for many investors, and the offering documents contained material omissions); SEC v. Haugen, Litigation Release No. 21429, 2010 SEC LEXIS 611 (March 3, 2010) (SEC found Haugen sold private placement offerings and made false representations that contradicted statements in the private placement memoranda); In Re Maria T. Giesige, Exchange Act Release No. 60000, 2009 SEC LEXIS 1756 (May 29, 2009) (SEC found that Giesige raised $1.49 million in a private placement that resembled a Ponzi scheme and failed to perform due diligence on the issuer prior to recommending that clients invest in the offering); In Re Christopher J. Johndrow, Exchange Act Release No. 59531, 2009 SEC LEXIS 617 (March 6, 2009) (Johndrow made misrepresentation about returns on distressed debt and instructed sales agents to engage in general solicitation); *Gibson v. SEC*, 2009 U.S. App. LEXIS 5243 (6th Cir. 2009) (Gibson misappropriated $450,000 of $875,000 in investor funds raised from the sale of limited partnership interests and made misrepresentations to investors); In Re Michael Frederick Siegel, Exchange Act Release No. 58737, 2008 SEC LEXIS 2459 (October 6, 2008) (Siegel made unsuitable recommendations and participated in private placement offerings without providing written notice to the firm); SEC v.

FINRA also has many formal investigations involving broker-dealer conduct in private placements that are active and ongoing. In 2011 alone, FINRA received over 1,100 customer complaints and other referrals involving private placements, and over 250 of these matters are currently open and under investigation.[20] In addition, FINRA has recently settled many cases regarding private placements.[21]

Alanar, Inc., 2008 U.S. Dist. LEXIS 37241 (S.D. Indiana, May 6, 2008) (defendants underwrote $120 million in bond offerings and then shuffled money between accounts to hide the default that would occur and misapplied and misappropriated repayments from bond issuing entities and made false and misleading statements to purchasers of bonds); SEC v. Becker, 2010 U.S. Dist. LEXIS 67828 (S.D.N.Y., July 8, 2010) (defendants raised $1.3 million in a private placement from several investors and misused the offering proceeds for their personal benefit); United States v. Mandell, 710 F. Supp. 2d 368 (S.D.N.Y. 2010) (defendants participated in scheme that solicited funds under false pretenses, misappropriated investor funds, and failed to use investor funds as promised); SEC v. Trujillo, 2010 U.S. Dist. LEXIS 99208 (D. Colo. Sept. 22, 2010) (defendants obtained investments in funds by making false and misleading statements to investors); SEC v. McGinn, Smith & Co., 752 F. Supp. 2d 194 (N.D.N.Y. 2010) (defendants misrepresented the investment and failed to conduct adequate due diligence in connection with the investment and the accreditation of investors); SEC v. Bravata, 763 F. Supp. 2d 891 (E.D. Mich. 2011) (defendants raised $50 million from hundreds of investors and misrepresented to investors that the proceeds would be used to acquire real estate, while only a portion of proceeds was spent on real estate acquisitions, and over $7 million was used for personal benefit, while conducting a Ponzi scheme that paid more than $11 million of new proceeds to earlier investors); and SEC v. Tecumseh Holdings Corp. 765 F. Supp. 2d 340 (S.D.N.Y. 2011) (defendants raised $10 million through material misrepresentations that include false and misleading profit projections, promised returns while concealing the fact that certain entities had no earnings, and made misleading statements related to an acquisition of broker-dealer).

[20] For example, in 2011, FINRA initiated formal disciplinary proceedings through the filing of a complaint in a number of investigations that involved problematic private placements. See, e.g., Dep't of Enforcement v. Eastridge, Complaint No. 2009020675401 (2011); Dep't of Enforcement v. Baldwin, Complaint No. 2009019632401 (2011); and Dep't of Enforcement v. Direct Capital Securities, Inc., Complaint No. 2008016023701 (2011).

[21] Pacific Cornerstone Capital, Inc., FINRA AWC No. 2007010591701 (2009); Michael D. Shaw, FINRA AWC No. 2010022963601 (2011); David E. Niederkrome, FINRA AWC No. 2008016403302 (2011); Dep't of Enforcement v. Hedge Fund Capital Partners LLC, Complaint No. 2006004122402, 2011 FINRA Discip. LEXIS 20 (hearing panel decision Jan.

In July 2009, the SEC brought actions involving two high-profile private placements, Medical Capital Holdings Inc. and Provident Royalties LLC. [22] Thousands of investors lost millions of dollars, including, for some, their life

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26, 2011); Dep't of Enforcement v. MICG Investment Management, LLC, Complaint No. 2009016230501 (2010); Brewer Financial Services, LLC., FINRA AWC No. 201023252701 and 20100245289 (2011); Nick N. Ichimaru, FINRA AWC No. 2009017628302 (2011); Dep't of Enforcement v. Kirkpatrick, Complaint No. 2006004666601, 2011 FINRA Discip. LEXIS 30 (hearing panel decision March 28, 2011); Dep't of Enforcement v. Tradespot Markets Inc., Complaint No. 2009017590801 (2011); Dep't of Enforcement v. McGinn, Smith & Co., Inc., Complaint No. 2009017984501 (2011); Dep't of Enforcement v. Steven Mark Peaslee, Complaint No. 2009020134201 (2011); Hernan Charry, Jr., FINRA AWC No. 2010022715607 (2011); William Slay Stevens, FINRA AWC No. 2010020829801 (2011); Timothy Dale House, FINRA AWC No. 2009017600401 (2011); Dep't of Enforcement v. Phillip Peter Borup, Complaint No. 20080143851-01 (2011); Mark A. Lakers, FINRA AWC No. 20060073538 (2008); Dep't of Enforcement v. Hackstedde, Complaint No. 2006004707201 (2009); CP Capital Securities, Inc., FINRA AWC No. 2007007145101 (2009); Eric Lawrence Bloom, FINRA AWC No. 2009016157801 (2011); Richard A. Pizzuti, FINRA AWC No. 200917195201 (2010); David Harry Michael Baudo, FINRA AWC No. 2010024861801 (2011); and Dep't of Enforcement v. Jeremy B. Shankster, Complaint No. 2009016927501 (2011) Askar Corp., FINRA AWC No. 2009018558601 (2011); Anthony Paul Campagna, FINRA AWC No. 2009017240701 (2011); Stephen Anthony Englese, FINRA AWC No. 2009017240703 (2011); and Equity Services, Inc., FINRA AWC No. 2009017240702 (2011).

[22] SEC v. Provident Royalties, LLC., SEC Litigation Release No. 21118, 2009 SEC LEXIS 2241 (July 7, 2009) (SEC alleges that private placement sold to investors used offerings documents that contained material omissions regarding the use of offering proceeds). SEC v. Medical Capital Holdings, Inc., SEC Litigation Release No. 21141, 2009 SEC LEXIS 2390 (July 20, 2009) (SEC alleges that defendants misappropriated investor funds and made misrepresentations to investors).

savings.[23] FINRA also brought multiple cases against firms that participated in these offerings and their relevant employees.[24]

State securities regulators also are bringing many enforcement cases involving private placements. The North American Securities Administrators Association ("NASAA") recently announced that in 2010, state regulators brought more than 250 actions involving Rule 506 or Regulation D offerings, which was cited as the most common type of products that led to or were at the center of state enforcement actions.[25]

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23 See Alexis Leondis, The Hidden Hazards of Private Placements, Investment Vehicles Intended for Sophisticated Wealthy Investors are Being Sold to Retirees Who Often Don't Understand the Risk, Bloomberg Businessweek, December 9, 2010, accessible at http://www.businessweek.com/magazine/content/10_51/b4208051661026.htm.

24 Provident Asset Management, LLC, FINRA AWC No. 2009017497201 (2010); Mark Mercier, FINRA AWC No. 2009019070901 (2011); Securities America, Inc., FINRA AWC No. 2010022518101 (2011); Investors Capital Corp., FINRA AWC No. 2009018609501 (2011); NEXT Financial Group, Inc., FINRA AWC No. 2009019063801 (2011); and John Milton Rose, FINRA AWC No. 2010022089101 (2011). Jeffrey Allen Lindsey, FINRA AWC No. 2009019125901 (2011); Cambridge Legacy Securities, LLC, FINRA AWC No. 2009020319001 (2010); Tyge Tuccillo, FINRA AWC No. 2010021240401 (2011); Garden States Securities, Inc. FINRA AWC No. 2009018819201 (2011); Thomas Timothy Cullum and Steven Lynn Burks, FINRA AWC No. 2009018818001 (2011); Vincent Michael Bruno, FINRA AWC No. 2009018771701 (2011); ACE Diversified Capital, Inc., FINRA AWC No. 2009020356901 (2011); Bradley Paul Wells, FINRA AWC No. 2009019125902 (2011); David William Dube, FINRA AWC No. 2008011713801 (2010); and Brian W. Boppre, FINRA AWC No. 2009019125904 (2011) Jay Lynn Thacker, FINRA AWC No. 200901970101 (2011); Leroy H. Paris, FINRA AWC No. 2009019070102 (2011); Newbridge Securities Corporation, FINRA AWC No. 2009016159401 (2011); Robin Fran Bush, FINRA AWC No. 2009016159402 (2011); Capital Financial Services, Inc., FINRA AWC No. 2009019125903 (2011); Robert Alan Vollbrecht, FINRA AWC No. 20090188184 (2011); Workman Securities Corporation, FINRA AWC No. 20090188184 (2011); and National Securities Corporation, FINRA AWC No. 2009019068201 (2011).

25 See NASAA 2010 Enforcement Report, prepared by the NASAA Enforcement Section (October 2011).

Disclosure to investors is a hallmark of the federal securities laws and, in FINRA's view, necessary for an efficient, fair and transparent offering process for private placements. The unsupported claims that narrowly-tailored disclosures in the Proposed Rule would impose unnecessary burdens on capital formation, given the recent enforcement activity and investor losses in the private placement market, constitute opinions uninformed by the facts. Moreover, FINRA is proposing to tailor the disclosure provisions to require disclosure only for those private placements in which disclosure documents prepared by or on behalf of the issuer are used.

Filing Requirements

The Proposed Rule would require each member that participates in a private placement to file the private placement memorandum, term sheet or such other disclosure document, and any exhibits thereto, with FINRA no later than 15 calendar days after the date of first sale. As discussed above, FINRA is proposing to alter the disclosure requirement so that members are not prohibited from participating in private placements in which a disclosure document is not used. For these types of private placements, members could not meet the filing requirements of the Proposed Rule. Consequently, FINRA is proposing to amend the filing requirement of the Proposed Rule as follows: for those private placements in which a disclosure document is used, a member (or designated manager acting on behalf of the member) will be required to file such document with FINRA no later than 15 calendar days after the date of first sale; for those private placements in which a disclosure document is not used, the participating member (or designated manager acting on behalf of the member) will be required to make a notice filing with FINRA no later than 15 calendar days after the date of first sale identifying the private placement (and participating members, if applicable) and stating that no disclosure document was used.

The notice filing requirement will offer a substantial benefit to the investing public and help FINRA to address the abusive practices in the private placement market by enabling FINRA to better monitor firms' compliance with their suitability obligations. The notice filing will come into a department with trained staff who will be dedicated to analyzing data contained in the notice filings to identify those that contain red flags. This initial triage function will be supplemented by a new, sophisticated filing system that FINRA is developing. For many filings that contain red flags, the department staff will contact members to make timely inquiries regarding the scope and results of their investigations pursuant to their suitability rule obligations. Other filings will be accessed through the filing system by FINRA examiners. FINRA believes that compilation of data on private offerings will lead to a more efficient and productive review of members' private placement activities and is expected to largely replace the current practice of requesting offering documents for firms individually in connection with routine and risk-based examinations. Notice filing by members participating in private placements in which disclosure documents were not provided to investors similarly will give FINRA important and timely

information to aid in its investigations and examinations. The notice filings also will make the examination of firms more efficient, by providing FINRA staff with a more complete picture of a member's private placement business before the firm is examined.

Several commenters believed that a single filing for each offering, rather than by each member, would be sufficient for the proposed rule's regulatory purposes and the firm making the filing could be tasked with disclosing the other members of the selling group in offerings in which more than one firm participated.[26] Based on these comments, FINRA proposes to add supplementary material to the Proposed Rule that would clarify that a single member of a selling group could file the disclosure document with FINRA on behalf of the entire selling group. The Proposed Rule would require the filing member to identify other members on whose behalf the filing is made.[27]

PIABA suggested that the timing of filing initial disclosure documents with FINRA should be consistent with that for amendments. Thus, it urged FINRA to require firms to file initial disclosure documents within 15 days after being provided to an investor or prospective investor. FINRA disagrees and believes that the timing in the Proposed Rule is appropriate. On the other hand, S&C suggested that the timing provisions be amended to make clear that an amendment to the disclosure document prior to the time of first sale need not be filed earlier than the filing of the initial disclosure document. As a result, FINRA proposes to clarify the timing of the filing requirement to indicate that the filing of amendments need not occur prior to the filing of initial disclosure documents.

NASAA continued to support a requirement that FINRA more thoroughly review private placements, including pre-offering and pre-sale reviews, as well as limit the amount of offering proceeds that can be used for offering costs and compensation. For the reasons provided in the original proposed rule change, as well as concerns about potential delays and effects on capital formation from an across-the-board limit on offering costs and compensation, FINRA has not incorporated these elements in the Proposed Rule.

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26 ABA; FSI; IPA; NYC Bar; REISA; S&C.

27 Every FINRA member has access to FINRA regulatory applications through the FINRA Firm Gateway. FINRA is developing a filing system for private placements subject to the Proposed Rule that will permit members to access the system via the FINRA Firm Gateway and download the private placement memorandum, term sheet or other disclosure document that will be required to be filed.

Exemptions

Commenters expressed concerns regarding exemptions, in most cases advocating to broaden proposed categories or to add new categories of exemptions. (NASAA, on the other hand, expressed the view that the exemptions are too extensive and should be limited further). Because, as discussed above, FINRA is proposing to revise the definition of private placement, FINRA believes that the more focused scope of the Proposed Rule will obviate the need to adopt some of the additional exemptions suggested by some commenters. However, many commenters also urged FINRA to consider adding or altering a number of other exemptions. As discussed below, FINRA proposes to add or clarify explicit exemptions for many of the categories suggested by the commenters.

M&A transactions. Two commenters urged FINRA to adopt an explicit exemption for M&A transactions.[28] In the original rule filing, FINRA provided that a member may apply for transaction-specific exemptions for good cause pursuant to the Rule 9600 Series. Commenters asserted, however, that this transaction-specific process would not be practical and that a categorical exemption for M&A transactions would provide a more workable solution and is warranted since such transactions are not for capital-raising. Upon further reflection and analysis of the comments, FINRA proposes to add an exemption for "business combination transactions" as defined in Securities Act Rule 165(f).

Employees and affiliates. Currently, the Proposed Rule provides an exemption for offerings sold to "employees and affiliates of the issuer."[29] The ABA suggested that FINRA exempt employees "of the issuer or its affiliates" and define affiliates to have the same meaning as in FINRA Rule 5121(f)(1). Cornell similarly urged more clarity regarding the term "affiliate," noting that different definitions of the term exist in the federal securities laws.[30] On the other hand, Cornell urged FINRA not to adopt the proposed exemption for employees and affiliates of the issuer on the basis that it is overly broad, vague and detrimental to many investors. It suggested that FINRA to limit the current exemption to more high-level employees of the issuer, noting that, while mid- to high-level employees of this issuer may be cognizant of the risks associated with the company, not all employees of the issuer have the same knowledge and thus should not be subject to an exemption from the Rule's requirements. FINRA believes the exemption to apply to all employees of the issuer is appropriately tailored. Based on both commenters' suggestions to clarify the meaning of "affiliate," FINRA

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[28] ABA; NYC Bar.

[29] See Proposed Rule 5123(c)(1)(G).

[30] See Cornell (noting the differing definitions of "affiliate" in SEC Rule 144 and Rule 12b-2 of SEC Regulation 12B).

will add supplementary material to the Proposed Rule noting that the term "affiliate" will have the same meaning as in Rule 5121.

Knowledgeable employees of private funds. A few commenters urged FINRA to adopt additional exemptions for "knowledgeable employees" of a private fund, as defined in Investment Act Rule 3c-5.[31] The ABA and K&L Gates urged FINRA to propose an exemption for knowledgeable employees of a private fund or of the investment adviser that sponsors or manages a private fund. They further provided that private funds differ from other issuers in several key respects, such as that the issuer does not have its own officers or employees; only offshore funds have their own directors; they are administered and managed by the affiliated investment adviser; and are wholly reliant on the officers and employees of the adviser to provide management services. MFA similarly noted that the Proposed Rule's exemption for qualified purchasers might not capture all "knowledgeable employees," who are permitted to purchases interests in certain private funds. Based on these comments, FINRA proposes to add an exception for knowledgeable employees of private funds, as that term is defined in Investment Act Rule 3c-5.

Other sophisticated investors and (3)(c)(1) funds. MFA noted that, based on the current proposed exemptions, it appears the exemptions "are designed in part to

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[31] ABA: K&L Gates; see also MFA. Investment Act Rule 3c-5 defines "knowledgeable employee" as any natural person who is:

(i) an Executive Officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of a Covered Company [i.e., a private fund] or an Affiliated Management Person [i.e., a person that manages the investment activities of a private fund];

(ii) an employee of the Covered Company or an Affiliated Management Person of the Covered Company (other than an employee performing solely clerical, secretarial or administrative functions with regard to such company or its investments) who, in connection with his or her regulatory functions or duties, participates in the investment activities of such Covered Company, other Covered Companies, or investment companies the investment activities of which are managed by such Affiliated Management Person of the Covered Company, *provided that* such employee has been performing such functions and duties for or on behalf of the Covered Company or the Affiliated Management Person of the Covered Company, or substantially similar functions of duties for or on behalf of another company for at least 12 months.

apply to certain private offerings made to sophisticated investors."[32] Based on this assumption, MFA advocates that other types of sophisticated investors, i.e., qualified clients[33] and accredited investors,[34] that are purchasers of private funds, should be

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32 MFA.

33 Investment Advisers Act Rule 205-3(d)(1) defines "qualified client" as

(i) a natural person who or a company that immediately after entering into the contract has at least $1 million under the management of the investment adviser;

(ii) a natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:

a. has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2 million at the time the contract is entered into; or

b. is a qualified purchaser ... at the time the contract is entered into; or

(iii) A natural person who immediately prior to entering into the contract is:

a. An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or

b. An employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

34 "Accredited Investor" is defined in Regulation D Rule 501(a) to include, among other things: any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1 million; and any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year. See Securities Act Rule 501(a)(6) and (7).

exempt from the requirements of the Proposed Rule. In addition, Moelis suggested an exemption for "employees of the broker dealer or its affiliates, who are accredited investors." FINRA does not agree with these suggestions. FINRA believes that the qualified client and accredited investor standards do not by themselves require a sufficiently high level of sophistication to warrant exception from the Proposed Rule. Similarly, accredited investors who are employees of a member or its affiliate are not necessarily sufficiently sophisticated to warrant exemption from the protections of the Proposed Rule. However, as discussed below, FINRA believes that there should be an exception for some "institutional" accredited investors.

The Proposed Rule contains an exemption for offerings that limit investors to qualified purchasers. Typically, private funds relying on this exemption are structured pursuant to Section 3(c)(7) of the Investment Company Act, and thus most 3(c)(7) funds would be exempt from the Proposed Rule. On the other hand, most funds structured pursuant to section 3(c)(1) of the Investment Company Act are structured to be offered and sold to accredited investors or qualified clients. As noted above, the Proposed Rule does not contain an exemption for accredited investors or qualified clients. One commenter requested that the Proposed Rule be revised to add an exemption for 3(c)(1) funds that meet two criteria: (1) all fund investors are accredited investors; and (2) the fund's adviser is registered with the SEC under the Advisers Act.[35] As described above, FINRA is not persuaded that the accredited investor standard warrants an exemption on its own; further, we are not persuaded that the requirement that registration by a fund's adviser would ensure sufficient disclosure or protection of private placements to investors.

The ABA noted that many private offerings involve offers and sales to sophisticated institutional investors who qualify as "institutional" accredited investors under Rule 501(a)(1), (2), (3) or (7) of Regulation D.[36] It asserted that such investors

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[35] NSCP. See also MFA.

[36] These "institutional" accredited investors are:

- banks and savings and loan associations, registered broker-dealers, insurance companies, investment companies, business development companies, Small Business Investment Companies, State employee benefit plans with assets in excess of $5 million; ERISA employee benefit plans, if the investment decision is made by a plan fiduciary which is either a bank, savings and loan association, insurance company or registered investment adviser, or if the employee benefit plan as total assets in excess of $5 million, or if a self-directed plan, with investment decisions made solely by persons that are accredited investors (see Rule 501(a)(1));

- private business development companies (see Rule 501(a)(2));

are fully capable of "fending for themselves," but do not meet the much higher monetary thresholds to fit within other exemptions. FINRA is persuaded that these categories of "institutional" accredited investors are the types with sufficient sophistication to warrant an exemption from the Proposed Rule. As a result, FINRA will add an exemption to paragraph (c)(1) of the Proposed Rule for offerings sold to those accredited investors described in Rule 501(a)(1), (2), (3) or (7) of Regulation D.

Affiliated closed-end registered investment company offerings. K&L Gates advocated that the Rule should exempt offerings of affiliated closed-end registered investment companies. It noted that disclosures for these offerings, whether public or private, are governed by Form N-2 under the Investment Company Act, and subject to review by the Commission staff upon filing. Because the content of Form N-2 addresses "all of the items in the Proposed Rule along with much more," K&L Gates asserted that requiring such offerings to be filed with FINRA pursuant to the Proposed Rule would be unnecessary, would impose additional costs on the fund and cause potential regulatory disparity and uncertainty. FINRA agrees that registration of a company under the Investment Company Act provides sufficient investor protections in lieu of the Proposed Rule and will add an exemption for the private placement of securities of a registered investment company.

Standardized options. Two commenters suggested an additional exemption for standardized options.[37] Pursuant to Securities Act Rule 238, standardized options are those issued by a clearing agency and traded on a national securities exchange. Because they are traded on exchanges, offered continuously, and cleared by a registered clearing agency, the commenters asserted that these securities lack many of the characteristics of private placements. FINRA agrees, and proposes to add an exemption for standardized options to the Proposed Rule.

Eligible contract participants. OCC advocated an exemption for cleared over-the-counter options, provided that such options are offered and sold exclusively to eligible contract participants ("ECPs"), as defined in Section 3(a)(65) of the Exchange Act. Similarly, the ABA advocated an exemption for private placements involving security-based swap agreements, which are generally limited to purchase or sale by ECPs. FINRA believes that ECPs are, like qualified purchasers, an appropriate

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- organizations described in Section 501(c)(3) of the Internal Revenue Code (see Rule 501(a)(3)); and

- trusts with total assets in excess of $5 million, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii) (see Rule 501(a)(7)).

[37] ABA; OCC.

category of investors to exempt from the Proposed Rule. As a result, FINRA will add an exemption for ECPs, as defined in Section 3(a)(65) of the Exchange Act, in the Proposed Rule. To the extent that a security-based swap is sold to an ECP, it will be exempt from the Proposed Rule.

Commercial paper exemption expansion. The NYC Bar urged FINRA to expand the commercial paper exemption in proposed Rule 5123(c)(4), which covers offerings of exempt securities with short term maturities under Section 3(a)(3) of the Securities Act.[38] It suggested that securities that do not meet the requirements of Section 3(a)(3) are also viewed as commercial paper and do not raise concerns regarding private placements. Thus, the NYC Bar suggested expanding the commercial paper exemption to also exempt debt securities offered and sold by FINRA members pursuant to Section 4(2) of the Securities Act so long as the maturity does not exceed 397 days and the securities are issued in minimum denominations of $150,000 (or the equivalent thereof in another currency).[39] Based on the NYC Bar's comment, FINRA proposes to expand the commercial paper exemption as described above.

Changes to exemption regarding non-convertible debt or preferred securities. Two commenters suggested minor wording changes to the exemption regarding non-convertible debt or preferred securities in proposed Rule 5123(c)(8).[40] As indicated in the proposed rule filing, FINRA proposed changes to this exemption in an attempt to conform with the Commission's recent removal of references to credit rating in certain rules and forms. FINRA finds the suggested wording changes acceptable and proposes to alter Rule 5123(c)(8) as suggested by the commenters to read as follows:

> Offerings of non-convertible debt or preferred securities that meet the transaction eligibility criteria for registering primary offerings of non-convertible securities on Forms S-3 and F-3.

Offerings subject to Rule 5110. FINRA Rule 5123(c)(11) exempts offerings filed under several other FINRA Rules, including Rule 5110. The ABA noted that

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[38] NYC Bar.

[39] NYC Bar. The commenter points out that this maturity limit conforms to the limit imposed by Rule 2a-7 under the Investment Company Act of 1940, which governs the nature of securities that may be invested in by money market funds (the primary purchasers of such securities). The minimum denomination requirement, which is also common in this market, would address any concern that such securities could be sold to retail investors, notwithstanding the predominance of money market funds and purchasers in this market.

[40] NYC Bar; S&C.

Rule 5110(b)(7) exempts certain offerings from filing, though the offering continues to be subject to the compensation, disclosure and other requirements of that Rule. Thus, the ABA asserted, these offerings should also be exempted from Rule 5123. FINRA notes that it did not intend to subject offerings that are exempt from filing under Rule 5110(b)(7), but subject to its other requirements, to the additional requirements of 5123. Accordingly, FINRA proposes to add language suggested by the ABA to clarify this point. The revised rule text will provide an exemption for a "offering filed with FINRA under Rule 2310, 5110, 5121 and 5122, *or exempt from filing thereunder in accordance with FINRA Rule 5110(b)(7).*" (italicized language added).

Other Comments

PIABA urged FINRA to remain vigilant in ensuring that members are following sales practices rules. It requested that FINRA be clear that the rule will not create a safe harbor for brokers. FINRA reiterates that the Proposed Rule in no way creates a safe harbor from any other obligations applicable to members or their associated persons including sales practice obligations.

REISA urged FINRA to make clear the penalties or liability that would attach for a failure to file or disclose, or timely file or timely disclose, information pursuant to the Proposed Rule. FINRA notes that, as for violations of any of its Rules, it could employ any of a wide range of regulatory responses available to it for violations of the Proposed Rule. FINRA's regulatory response would depend on the facts and circumstances of the violation in question.

NASAA expressed concern regarding the confidentiality provision, noting that investors and their counsel should have a right to easy access to filings made with FINRA. As noted in the original proposed rule change, FINRA plans to use documents filed with it solely for the purpose of determining compliance with FINRA rules or other regulatory purposes, and thus proposes to accord confidential treatment to such documents. FINRA currently accords such confidential treatment to documents received pursuant to Rule 5122.

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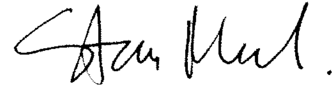
FINRA believes that the foregoing responds to the material issues raised by the commenters to this rule filing. If you have any questions, please contact Gary Goldsholle, Vice President and Associate General Counsel, at (202) 728-8104; or me at (202) 728-8056.

Sincerely,



Stan Macel
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