

Required fields are shown with yellow backgrounds and asterisks.

Page 1 of * <input type="text" value="37"/>	SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 Form 19b-4	File No.* SR - <input type="text" value="2020"/> - * <input type="text" value="038"/>	Amendment No. (req. for Amendments *) <input type="text"/>
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Filing by Financial Industry Regulatory Authority  
Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial * <input checked="" type="checkbox"/>	Amendment * <input type="checkbox"/>	Withdrawal <input type="checkbox"/>	Section 19(b)(2) * <input checked="" type="checkbox"/>	Section 19(b)(3)(A) * <input type="checkbox"/>	Section 19(b)(3)(B) * <input type="checkbox"/>
			Rule		
Pilot <input type="checkbox"/>	Extension of Time Period for Commission Action * <input type="checkbox"/>	Date Expires * <input type="text"/>	<input type="checkbox"/> 19b-4(f)(1)	<input type="checkbox"/> 19b-4(f)(4)	<input type="checkbox"/> 19b-4(f)(6)
			<input type="checkbox"/> 19b-4(f)(2)	<input type="checkbox"/> 19b-4(f)(5)	
			<input type="checkbox"/> 19b-4(f)(3)	<input type="checkbox"/> 19b-4(f)(6)	

Notice of proposed change pursuant to the Payment, Clearing, and Settlement Act of 2010	Security-Based Swap Submission pursuant to the Securities Exchange Act of 1934
Section 806(e)(1) * <input type="checkbox"/>	Section 806(e)(2) * <input type="checkbox"/>
Section 3C(b)(2) * <input type="checkbox"/>	

Exhibit 2 Sent As Paper Document <input type="checkbox"/>	Exhibit 3 Sent As Paper Document <input type="checkbox"/>
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**Description**

Provide a brief description of the action (limit 250 characters, required when Initial is checked \*).

Proposed Amendments to FINRA Rules 5122 (Private Placements of Securities Issued by Members) and 5123 (Private Placements of Securities) that Would Require Members to File Retail Communications Concerning Private Placement Offerings

**Contact Information**

Provide the name, telephone number, and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the action.

First Name * <input type="text" value="Joseph"/>	Last Name * <input type="text" value="Savage"/>
Title * <input type="text" value="Vice President, OGC Regulatory Analysis"/>	
E-mail * <input type="text" value="joe.savage@finra.org"/>	
Telephone * <input type="text" value="(240) 386-4534"/>	Fax <input type="text" value="(202) 728-8264"/>

**Signature**

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

(Title \*)

Date <input type="text" value="10/28/2020"/>	<input type="text" value="Senior Vice President and Deputy General Counsel"/>
By <input type="text" value="Patrice Gliniecki"/>	<input type="text" value="Patrice Gliniecki"/>

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFF website.

**Form 19b-4 Information \***

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

**Exhibit 1 - Notice of Proposed Rule Change \***

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 1A- Notice of Proposed Rule Change, Security-Based Swap Submission, or Advance Notice by Clearing Agencies \***

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change, security-based swap submission, or advance notice being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications**

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Exhibit Sent As Paper Document

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

**Exhibit 3 - Form, Report, or Questionnaire**

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Exhibit Sent As Paper Document

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

**Exhibit 4 - Marked Copies**

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

**Exhibit 5 - Proposed Rule Text**

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The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

**Partial Amendment**

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

**1. Text of the Proposed Rule Change**

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act,” “Exchange Act” or “SEA”),<sup>1</sup> Financial Industry Regulatory Authority, Inc. (“FINRA”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) proposed amendments to FINRA Rules 5122 (Private Placements of Securities Issued by Members) and 5123 (Private Placements of Securities) that would require members to file retail communications concerning private placement offerings that are subject to those rules’ filing requirements.

The text of the proposed rule change is attached as Exhibit 5.

(b) Not applicable.

(c) Not applicable.

**2. Procedures of the Self-Regulatory Organization**

The FINRA Board of Governors has authorized the filing of the proposed rule change with the SEC. No other action by FINRA is necessary for the filing of the proposed rule change.

If the Commission approves the proposed rule change, FINRA will announce the effective date of the rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

3. **Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

(a) Purpose

FINRA Rules 5122 and 5123

Rule 5122 applies to private placements of unregistered securities issued by a member or a control entity<sup>2</sup> (“member private offerings”). The rule requires the member or control entity to provide prospective investors with a private placement memorandum (“PPM”), term sheet or other offering document that discloses the intended use of the offering proceeds, the offering expenses and the amount of selling compensation that will be paid to the member and its associated persons.

The rule also requires a member to file the PPM, term sheet or other offering document with the FINRA Corporate Financing Department (“Corp Fin”) at or prior to the first time the document is provided to any prospective investor.<sup>3</sup> Many member private offerings are exempt from the rule’s requirements, including among others, offerings sold only to institutional accounts, as defined in FINRA Rule 4512(c),<sup>4</sup>

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<sup>2</sup> A “control entity” means any entity that controls or is under common control with a member, or that is controlled by a member or its associated persons. See FINRA Rule 5122(a)(2). Control means beneficial interest, as defined in FINRA Rule 5130(i)(1), of more than 50 percent of the outstanding voting securities of a corporation, or the right to more than 50 percent of the distributable profits or losses of a partnership or other non-corporate legal entity. Control is determined immediately after the closing of an offering, and in the case of an offering with multiple intended closings, immediately following each closing. See FINRA Rule 5122(a)(3).

<sup>3</sup> Rule 5122 also requires the filing of any amendments to such documents within 10 days of being provided to any investor or prospective investor. See FINRA Rule 5122(b)(2).

<sup>4</sup> Rule 4512(c) defines “institutional account” as the account of:

qualified purchasers, as defined in the Investment Company Act of 1940,<sup>5</sup> and qualified institutional buyers,<sup>6</sup> as defined in Rule 144A under the Securities Act of 1933 (“Securities Act”).<sup>7</sup>

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- (1) a bank, savings and loan association, insurance company or registered investment company;
  - (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act or with a state securities commission (or any agency or office performing like functions); or
  - (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million.

<sup>5</sup> See 15 U.S.C. 80a-2(a)(51).

<sup>6</sup> See 17 CFR 230.144A(a)(1).

<sup>7</sup> Rule 5122 exempts the following member private offerings:

- (1) offerings sold solely to:
  - (A) institutional accounts, as defined in Rule 4512(c);
  - (B) qualified purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act;
  - (C) qualified institutional buyers, as defined in Securities Act Rule 144A;
  - (D) investment companies, as defined in Section 3 of the Investment Company Act;
  - (E) an entity composed exclusively of qualified institutional buyers, as defined in Securities Act Rule 144A; and
  - (F) banks, as defined in Section 3(a)(2) of the Securities Act;
- (2) offerings of exempted securities, as defined in Section 3(a)(12) of the Exchange Act;
- (3) offerings made pursuant to Securities Act Rule 144A or Regulation S;
- (4) offerings in which a member acts primarily in a wholesaling capacity (i.e., it intends, as evidenced by a selling agreement, to sell through its affiliate broker-dealers, less than 20% of the securities in the offering);
- (5) offerings of exempt securities with short term maturities under Section 3(a)(3) of the Securities Act;
- (6) offerings of subordinated loans under Exchange Act Rule 15c3-1, Appendix D (see NASD Notice to Members 02-32 (June 2002));
- (7) offerings of “variable contracts”, as defined in FINRA Rule 2320(b);
- (8) offerings of modified guaranteed annuity contracts and modified guaranteed life insurance policies, as referenced in FINRA Rule 5110(h)(2)(D);

Rule 5123 requires members to file with FINRA any PPM, term sheet or other offering document, including any material amended versions thereof, used in connection with a private placement of securities within 15 calendar days of the date of first sale. Rule 5123 exempts private placements that are filed under other FINRA Corporate Financing Rules, as well as most of the same categories of private placements that are exempt from filing under Rule 5122.<sup>8</sup> As a result of these exemptions, both rules apply predominately to private placements sold to retail investors.

FINRA received 2,509 unique Rule 5122 and 5123 filings in 2019. FINRA uses analytics to conduct a risk-based review for each filing. This analysis of an offering's risk to investors and its ability to identify potential rule violations and other potential

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- (9) offerings of unregistered investment grade rated debt and preferred securities;
  - (10) offerings to employees and affiliates of the issuer or its control entities;
  - (11) offerings of securities issued in conversions, stock splits and restructuring transactions that are executed by an already existing investor without the need for additional consideration or investments on the part of the investor;
  - (12) offerings of securities of a commodity pool operated by a commodity pool operator, as defined under Section 1a(5) of the Commodity Exchange Act;
  - (13) offerings of equity and credit derivatives, including OTC options; provided that the derivative is not based principally on the member or any of its control entities; and
  - (14) offerings filed with Corp Fin under FINRA Rules 2310, 5110 or Rule 5121.

<sup>8</sup> See FINRA Rule 5123(b); see also note 7, *supra*. In addition to the exemptions contained in Rule 5122, Rule 5123(b) exempts offerings sold by the member or person associated with the member to (a) employees and affiliates, as defined in Rule 5121, of the issuer; (b) knowledgeable employees as defined in Investment Company Act Rule 3c-5; (c) eligible contract participants, as defined in Section 3(a)(65) of the Exchange Act; and (d) accredited investors described in Securities Act Rule 501(a)(1), (2), (3), and (7); and exempts business combination transactions as defined in Securities Act Rule 165(f), and standardized options as defined in Securities Act Rule 238.

problems begins with the information and documents submitted. Members that sell private placements may use a PPM or term sheet alone, or may use a variety of other offering documents in addition to, or instead of, a PPM or term sheet.

Because members use a wide variety of materials, Rules 5122 and 5123 do not enumerate the types of information that might be considered “offering documents.” FINRA has stated previously that an example of “other offering document” is “[a]ny other type of document that sets forth the terms of the offering.”<sup>9</sup> The terms of an offering include facts such as the amount of proceeds that the issuer intends to raise, the type of security, descriptions or illustrations of the intended use of proceeds, and explanations of tax benefits or other information that would be relevant to an investor when deciding whether to make an investment.

While Rules 5122 and 5123 do not require retail communications governed by Rule 2210 (Communications with the Public) to be filed, many members file these communications with their required documents.<sup>10</sup> Examples of these retail communications can include web pages that promote the offering, slide presentations, pitch decks, one-page “teasers,” fact sheets, sales brochures, executive summaries, and investor packets. Corp Fin often forwards these retail communications to FINRA’s Advertising Regulation Department (“AdReg”) for review.

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<sup>9</sup> See “Frequently Asked Questions (FAQ) About Private Placements,” Question #10, available on [www.finra.org](http://www.finra.org).

<sup>10</sup> See Regulatory Notice 09-27 (May 2009), which announced SEC approval of Rule 5122, stated that the rule imposes no additional requirements regarding the filing of advertisements or sales materials. However, as noted, many firms do in fact file retail communications concerning private placements under Rules 5122 and 5123.

Corp Fin staff triages the filings it receives under Rules 5122 and 5123 using a variety of criteria and selects a subset for further analysis and review based on the relative risk of the offering. In some cases, FINRA opens investigations of particular offerings, which may lead to follow-up examinations by Member Supervision staff, and potentially, referrals to the Department of Enforcement.

Advertising Regulation Review of Private Placement Retail Communications

In addition to reviewing private placement retail communications that are filed under Rules 5122 and 5123 and referred by Corp Fin, AdReg reviews private placement retail communications that it receives through one of four other channels: (i) new member and voluntary filings with AdReg; (ii) referrals from the Member Supervision examination program and other surveillance groups; (iii) AdReg spot checks; and (iv) assistance in Enforcement cases.

AdReg has observed that retail communications that have been directly filed by new members<sup>11</sup> or voluntarily with AdReg for private placements raise more compliance issues than those for other products. Between January 1, 2017, and March 31, 2020, AdReg reviewed 1,726 new member and voluntary filings of private placement retail communications. Of these filings, 41% required revisions to comply with applicable standards, and 4% were so noncompliant with the rules that FINRA issued “do not use”

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<sup>11</sup> Rule 2210(c)(1)(A) requires new members to file all widely-distributed retail communications (such as publicly available websites) that promote products or services of the firm during the first year after the member’s broker-dealer membership with FINRA is declared effective.



(DNU) review letters. In comparison, during this same period, only 8% of overall AdReg filings reviewed required revisions, and only 0.1% received a DNU letter.<sup>12</sup>

In 2018, AdReg conducted a spot check of the private placement retail communications provided to Corp Fin in connection with filings under Rules 5122 and 5123 during the second and third quarters of 2018. The review revealed significant and pervasive violations of Rule 2210; overall, 806 of the 1,062 retail communications reviewed (76%) did not comply with Rule 2210.

The most common violation was the inclusion of prohibited projections of performance or unreasonable forecasts, e.g., “Return 4-6x invested capital net of fees” and “Management projects a \$100 million revenue stream can be built in 5 years.” Numerous others contained false or misleading statements, e.g., “Safety of Principle” [*sic*] and “UTILIZES AI & MACHINE LEARNING TECHNOLOGY SIMILAR TO THAT USED BY ONLINE GIANTS SUCH AS FACEBOOK, NETFLIX, AMAZON AND STITCH FIX.” Another common issue was the failure to balance promotional content with the key risks associated with the investment, such as a real estate offering touting the benefit of purchasing properties leased by “investment grade” tenants without discussing that such holdings do not assure a profit or protect against loss. Others failed to disclose general risks, such as the speculative nature of the securities and the lack of liquidity of the investment.

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<sup>12</sup> During the same period, AdReg analyzed 1,328 private placement retail communications that were referred from Corp Fin, Member Supervision, or other FINRA departments. Seventy-one percent (71%) of these communications required revisions to comply with applicable standards and 13% resulted in a DNU letter. In contrast, 66% of all communications referred by other FINRA staff were determined to require revisions and 4% resulted in a DNU letter.

Private placement retail communications also feature prominently in FINRA's Enforcement program. Since January 1, 2014, FINRA has initiated 49 disciplinary actions related to non-compliant retail communications concerning private placements. This number represents 21% of all actions involving private placements.

### Filing Proposal

Given the comparatively high rate of non-compliance of private placement retail communications, and the increased risk of investor harm associated with those communications, FINRA proposes to amend Rules 5122 and 5123 to require such retail communications to be filed, in addition to the currently required PPMs, term sheets, and other offering documents.

Rules 5122 and 5123 focus on the private placements that raise the greatest concerns—those sold to retail investors, whether or not accredited. FINRA proposes to limit the new filing requirement to the same offerings; it would not apply to any offerings that are currently exempt from filing.<sup>13</sup> A member would be required to file with FINRA such retail communications no later than the date on which a filing is required under Rules 5122 and 5123.<sup>14</sup> The proposal would not require members to file private

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<sup>13</sup> See supra notes 7 and 8.

<sup>14</sup> As discussed above, Rule 5122 requires a member subject to the rule to file the PPM, term sheet or other offering document with FINRA at or no later than the first time the document is provided to a prospective investor. Any amendments or exhibits to such offering documents also must be filed with FINRA within 10 days of being provided to any investor or prospective investor. See Rule 5122(b)(2). Rule 5123 requires a member subject to the rule to file with FINRA the PPM, term sheet or other offering document, including any materially amended versions thereof, used in connection with the sale of securities covered by the rule within 15 calendar days of the date of first sale, or notify FINRA that no such offering documents were used. See Rule 5123(a).

placement retail communications for offerings that are not subject to the filing requirements in Rules 5122 or 5123, such as sales exclusively to institutional accounts. Moreover, because Rules 5122 and 5123 do not impose any filing fees, members would not be subject to higher fees because of this additional filing requirement. FINRA anticipates that members would be able to file most retail communications at the same time and in the same manner that they file their PPMs, term sheets, and other offering documents. The rules' requirements that material amendments to offering documents must be filed also would apply to retail communications.

As noted in Item 2 of this filing, if the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval.

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>15</sup> 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. FINRA believes that requiring the filing of retail communications under Rules 5122 and 5123 will improve members' compliance and understanding of the application

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<sup>15</sup> 15 U.S.C. 78o-3(b)(6).

of FINRA's communications with the public rules and reduce the likelihood that retail investors would receive false or misleading sales material for private placements.<sup>16</sup>

**4. Self-Regulatory Organization's Statement on Burden on Competition**

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

Economic Impact Assessment

FINRA has undertaken an economic impact assessment, as set forth below, to analyze the regulatory need for the proposed rule change, its potential economic impacts, including anticipated costs, benefits, and competitive effects, relative to the current baseline, and the alternatives FINRA considered in assessing how best to meet FINRA's regulatory objectives.

Regulatory Need

As discussed above, FINRA has seen significant problems with the retail communications that have been voluntarily filed under Rules 5122 and 5123. In addition, as noted above, the 2018 spot check revealed that 76% of retail communications filed under Rules 5122 and 5123 during the spot check review period involved significant violations of Rule 2210.<sup>17</sup> It is possible that significant violations may be even more

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<sup>16</sup> FINRA recently issued a Regulatory Notice providing guidance under Rule 2210 to firms that distribute retail communications concerning private placements. See Regulatory Notice 20-21 (July 1, 2020).

<sup>17</sup> Among the retail communications reviewed, 45% contained prohibited projections or unreasonable forecasts; 44.6% failed to provide a sound basis to evaluate the facts with respect to the offering in that the benefits articulated in the marketing materials were not balanced by key specific risks associated with an

prevalent among retail communications that have not been voluntarily filed or reviewed. Moreover, high-risk retail communications concerning private placements feature prominently in FINRA's Enforcement program.<sup>18</sup> These communications often present false or misleading information regarding the underlying offering, which could result in significant losses to investors and could undermine public trust in the private placement markets. The proposed amendments, therefore, are intended to promote investor protection and market integrity by expanding FINRA's oversight of high-risk retail communications concerning private placements.

#### Economic Baseline

The economic baseline includes the current regulation of retail communications under Rule 2210 and current regulation of specified private placements under Rules 5122 and 5123. All retail communications are required to comply with the general, fair and balanced standards detailed in Rule 2210; however, Rule 2210 generally does not require members to file with FINRA the materials they use to communicate with retail investors concerning private placements. Under Rules 5122 and 5123, members are required to file with FINRA any PPM, term sheet, or other offering document used in connection with specified private placements, although these rules do not currently require retail

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investment or the issuer; 39.9% failed to adequately disclose the general risks associated with private placement investments; 21.8% contained readily apparent false or misleading statements or claims; and 7.4% contained misleading references to FINRA, other regulators, or the benefits of regulation generally.

<sup>18</sup> As mentioned earlier, retail communications concerning private placements resulted in 49 FINRA disciplinary actions since January 2014, representing 21% of FINRA's disciplinary actions involving private placements during the period.

communications governed by Rule 2210 to be filed. Therefore, firms currently have no regulatory obligation to submit these communications for review by FINRA.

The economic baseline also includes members' existing practices under Rules 2210, 5122 and 5123. Currently, some members submit retail communications as part of their Rules 5122 and 5123 private placement filings with Corp Fin; some members file these communications through AdReg's filings review program under Rule 2210 either voluntarily or as new members; and some members submit these communications to both or neither of these departments.

As discussed above, upon receiving filings under Rules 5122 and 5123, Corp Fin triages the filings to select a subset for further review based on the relative risk of the offering. Corp Fin notifies AdReg when it receives retail communications in connection with the higher-risk offerings it assigns for reviews. AdReg then conducts its own triage program based on the relative risk of these retail communications.

Once high-risk retail communications are identified, AdReg requests Corp Fin to refer them to AdReg and opens a complex review matter to assess whether the communications meet applicable communication standards. If apparent rule violations are identified, AdReg will, as needed, provide an analysis for an existing Corp Fin investigation or contact the member firm to explain the concerns, ask the firm to remediate the communications, and determine the extent of the communications' use. AdReg may resolve the matter with informal disciplinary action or, if severe violations are identified, may refer the matter to FINRA's Department of Enforcement.<sup>19</sup>

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<sup>19</sup> A similar procedure is followed when AdReg receives referrals from the Member Supervision examination program or other surveillance groups.

The existing regulatory procedure concerning private placement retail communications that are filed with AdReg under Rule 2210 voluntarily or by new members adopts a different approach from the above. AdReg conducts a review in response to each retail communication filing and provides a review letter indicating whether the communication appears to be consistent with the applicable standards, and if not, the bases for this determination.<sup>20</sup>

FINRA has collected information for assessing the specified private placement market under Rules 5122 and 5123. On average, FINRA receives approximately 2,400 new offering filings annually, with approximately 10-15% of the filings representing a duplicate filing by separate firms with respect to the same offering. As a reference, the Regulation D data published by the SEC's Division of Economic and Risk Analysis in August 2018 provided that approximately 20,000 new offering filings on average were submitted via EDGAR each year from 2015 to 2017. Of this total, roughly 4,000 (or 20%) of the new offerings that SEC identified involved "intermediaries" such as brokers or finders, some of which may not be FINRA members. Accordingly, FINRA's private placement review program under Rules 5122 and 5123 accounts for approximately half of the new offerings filed with the SEC that involve intermediaries and approximately 10% of all new offering filings annually.

To assess how likely the specified private placements use retail communications, FINRA has analyzed information pertaining to 1,327 offerings filed with Corp Fin under

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<sup>20</sup> Unlike Corp Fin's private placement review program under Rules 5122 and 5123, filings through AdReg's filings review program under Rule 2210 are subject to filing fees.

Rules 5122 and 5123 during the second and third quarters of 2018.<sup>21</sup> Approximately 781 (or 59%) of the offerings did not include retail communications as part of the filing. There were 1,062 retail communications submitted by 132 members for the remaining 546 offerings.<sup>22</sup> The average (maximum) number of retail communications submitted per member among these offerings was eight (260), respectively. The average (maximum) number of retail communications per offering was approximately two (23) retail communications.

To further assess the existing regulatory procedure under Rules 5122 and 5123, FINRA collected review information regarding the 708 private placement filings with Corp Fin over the period February 1, 2020 to April 17, 2020.<sup>23</sup> Corp Fin identified 274 (or 38.7%) of filings that contained retail communications during this period. Among these 274 filings, 37 (or 13.5%) were deemed by Corp Fin to be high risk. AdReg triaged the retail communications in these 37 filings and determined that 14 represented likely significant violations of Rule 2210 and opened 14 complex review matters. These 14

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<sup>21</sup> The information was collected by AdReg in the 2018 spot check. There were 2,269 filings inclusive of amendments by 309 member firms related to the 1,327 offerings. Among them, 1,208 had projected proceeds totaling \$37.6B while projected proceeds were unknown for other offerings.

<sup>22</sup> Among the 546 offerings that included retail communications, 524 of them had projected proceeds totaling \$10.8B with projected proceeds unknown for the remaining offerings.

<sup>23</sup> This sample is different from the previous sample of the 2018 spot check: it is based on the most recent period for which FINRA has reliable data on its triage and review process.



matters represented 5% of all filings containing retail communications under Rules 5122 and 5123 during this period.<sup>24</sup>

#### Economic Impacts

The proposed rule change would directly impact members that distribute retail communications concerning specified private placements by requiring them to submit these communications to Corp Fin at the time they file the PPM, term sheet, or other offering document. Such an impact would be more pronounced for members that have not been voluntarily filing private placement retail communications with Corp Fin or AdReg. FINRA anticipates a considerable increase in the number of retail communications filed under Rules 5122 and 5123 as a result of the proposal. As was found during the 2018 spot check, approximately 41% of the offerings included retail communications voluntarily submitted concerning these offerings. If each offering is associated with an average of two retail communications, then the number of retail communications could be increased by 3,124 retail communications annually, totaling 5,308 retail communications per year.

The estimate of two retail communications per offering may overstate or understate the true amount. Note that the average of two retail communications per offering found during the spot check may understate the true average if members did not voluntarily file all retail communications associated with these offerings. Alternatively, the average retail communications per offering could be lower than two if there were

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<sup>24</sup> FINRA recognizes that the percentage of retail communications selected for complex review at any point in time (including after the proposed rule change) may deviate from 5%, as the time period used for deriving the estimate might be too short to draw reliable inferences.

many offerings that did not submit any retail communications because they did not distribute any such communications.

In developing the proposal, FINRA staff does not expect it to have a significant impact on AdReg's existing filings review program. Members will continue to have the option (but not the obligation) to file these communications through AdReg's filings review program following the proposal.<sup>25</sup>

The primary benefit of the proposed rule change would arise from FINRA's enhanced insight into and oversight of retail communications concerning high-risk private placements.<sup>26</sup> Specifically, the proposed amendments would enable FINRA to review all retail communications concerning the specified private placements through its triage program and if warranted, open cases for complex review, thereby extending FINRA's ability to potentially uncover significant violations of Rule 2210. In addition, retail communications that have not been filed voluntarily with Corp Fin or AdReg may have contained violations of greater severity or presented novel regulatory issues unknown to FINRA. By allowing access to retail communications concerning private placements from all filing members, the proposal would help FINRA staff understand the

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<sup>25</sup> FINRA believes that some members will continue to have incentives to file voluntarily retail communications through AdReg's filings review program following the proposed amendments. For instance, members and related parties may still benefit from a review letter indicating the material is consistent with applicable standards.

<sup>26</sup> FINRA recognizes that the proposal would not likely impact FINRA's oversight of low-risk offerings or low-risk retail communications as defined by the current triage process.

scope and severity of existing issues in a more accurate and efficient manner, which would further enhance FINRA's surveillance and enforcement program.<sup>27</sup>

The proposal likely would increase members' incentives to distribute retail communications concerning private placements that are fair and balanced and deter them from presenting false or misleading information that may cause investor harm. The proposed change may also likely increase issuers' incentives to disclose the risks of private placements in a fair and balanced manner in connection with retail communications, thereby enhancing the capabilities of investors and other related parties to assess these risks as part of their investment decisions.

FINRA believes that greater regulatory oversight, together with changes in members' and issuers' incentives, would help promote greater investor protection and public trust in the private placement markets. The benefit from enhanced incentives and regulatory oversight would more likely accrue with respect to members that frequently file private placements that include retail communications. FINRA recognizes that the proposal's investor protection benefits may be limited given that members are required to file private placement offerings within 15 calendar days of the date of first sale under Rule 5123. (Rule 5122 requires member private offerings to be filed at or prior to the date of first sale.) The proposal's investor protection benefits also may vary depending on how long the Corp Fin triage process takes and how quickly AdReg triages and reviews the communications and the available remedying tools.

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<sup>27</sup> Although FINRA does not anticipate immediate changes to its existing triage programs, the additional knowledge that FINRA would acquire following the proposal could potentially help FINRA refine its triage programs in the long run.

FINRA believes that the proposal would impose a minimal increase in direct costs to members that have not already been voluntarily filing private placement retail communications with Corp Fin. Specifically, the proposal would require these members to file any additional retail communications that promote the offering at the time they file the PPM or term sheet. Members also would be required to file retail communications subsequent to the initial filing if they distribute new retail communications promoting the offering or make material changes to any previously filed retail communications. FINRA believes such increases in direct costs would be minimal as Rules 5122 and 5123 do not impose filing fees, and most filing members are already familiar with the Corp Fin filing system.<sup>28</sup>

FINRA recognizes that members that distribute high-risk retail communications concerning private placements may be subject to additional regulatory review by FINRA as FINRA anticipates an expansion in its complex review program following the proposal.<sup>29</sup> FINRA believes the overall increase in regulatory costs and uncertainty to members associated with the additional review would likely be low because only a very small percentage of retail communications with the highest risk profile would be subject

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<sup>28</sup> FINRA believes that increases in direct costs may be even lower for members that have been voluntarily filing private placement retail communications with AdReg because they may already be familiar with the applicable standards under Rule 2210. These members will also have the option to file private placement retail communications only with Corp Fin following the rule proposal. This option could lead to a reduction in the filing fee for these members. However, should firms choose to file only with Corp Fin, there will not be a guaranteed review or review letter from FINRA.

<sup>29</sup> FINRA recognizes that misidentifications of high-risk matters (i.e., subjecting members that are less likely to pose a high risk to investors to the additional complex review) may induce unintended indirect costs on these members.

to the review. FINRA does not expect increases in direct and indirect costs will deter firm entry or private placement offerings or result in any significant burden on competition that is not necessary or appropriate in furtherance of the purpose of the Exchange Act.

#### Alternative Considered

FINRA considered proposing an amendment to Rule 2210 that would require members to submit private placement retail communications through AdReg's filings review program. AdReg would review all private placement retail communications filed under the alternative proposal. The alternative, therefore, would enhance FINRA's oversight of both high-risk and low-risk private placement retail communications, leading to significant improvement in members' compliance and understanding of applicable rules and greater benefit from market integrity and investor protection.

The alternative, however, would impose higher costs on members for several reasons. First, members would be subject to filing fees under Rule 2210, which would not apply to filings made under Rules 5122 or 5123. Second, members would have to file retail communications and offering documents separately with AdReg and Corp Fin using different filing systems. Third, all filing members would face additional regulatory costs and uncertainty while the review is pending.<sup>30</sup> FINRA is also concerned that the

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<sup>30</sup> The filing requirements under Rules 5122 and 5123 are notice filings only and members do not wait for approval from FINRA in connection with a private placement. However, if FINRA asks questions of the member in response to its filing, the member may become concerned that there may be a potential compliance issue with the private placement or related documents. Similarly, the filing requirement under Rule 2210 may not have required the member to be issued a review letter from FINRA before using a retail communication.

alternative approach may divert limited regulatory resources from high-risk matters. Overall, FINRA believes that the current proposal would build on the risk-based regulatory approach for private placements thereby promoting regulatory consistency and impose lower costs to members than the alternative FINRA has considered.

**5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others**

Written comments were neither solicited nor received.

**6. Extension of Time Period for Commission Action**

FINRA does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.<sup>31</sup>

**7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)**

Not applicable.

**8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission**

Not applicable.

**9. Security-Based Swap Submissions Filed Pursuant to Section 3C of the Act**

Not applicable.

**10. Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act**

Not applicable.

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However, some members may wait until the letter is received before using such communication.

<sup>31</sup> 15 U.S.C. 78s(b)(2).

**11. Exhibits**

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 5. Text of the proposed rule change.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34- ; File No. SR-FINRA-2020-038)

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Amendments to FINRA Rules 5122 (Private Placements of Securities Issued by Members) and 5123 (Private Placements of Securities) that Would Require Members to File Retail Communications Concerning Private Placement Offerings that are Subject to Those Rules' Filing Requirements

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on , the Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend FINRA Rules 5122 (Private Placements of Securities Issued by Members) and 5123 (Private Placements of Securities) that would require members to file retail communications concerning private placement offerings that are subject to those rules' filing requirements.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.



The text of the proposed rule change is available on FINRA's website at <http://www.finra.org>, at the principal office of FINRA and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

FINRA Rules 5122 and 5123

Rule 5122 applies to private placements of unregistered securities issued by a member or a control entity<sup>3</sup> ("member private offerings"). The rule requires the member or control entity to provide prospective investors with a private placement memorandum ("PPM"), term sheet or other offering document that discloses the intended use of the

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<sup>3</sup> A "control entity" means any entity that controls or is under common control with a member, or that is controlled by a member or its associated persons. See FINRA Rule 5122(a)(2). Control means beneficial interest, as defined in FINRA Rule 5130(i)(1), of more than 50 percent of the outstanding voting shares of a corporation, or the right to more than 50 percent of the distributable profits or losses of a partnership or other non-corporate legal entity. Control is determined immediately after the closing of an offering, and in the case of an offering with multiple intended closings, immediately following each closing. See FINRA Rule 5122(a)(3).

offering proceeds, the offering expenses and the amount of selling compensation that will be paid to the member and its associated persons.

The rule also requires a member to file the PPM, term sheet or other offering document with the FINRA Corporate Financing Department (“Corp Fin”) at or prior to the first time the document is provided to any prospective investor.<sup>4</sup> Many member private offerings are exempt from the rule’s requirements, including among others, offerings sold only to institutional accounts, as defined in FINRA Rule 4512(c),<sup>5</sup> qualified purchasers, as defined in the Investment Company Act of 1940,<sup>6</sup> and qualified institutional buyers,<sup>7</sup> as defined in Rule 144A under the Securities Act of 1933 (“Securities Act”).<sup>8</sup>

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<sup>4</sup> Rule 5122 also requires the filing of any amendments to such documents within 10 days of being provided to any investor or prospective investor. See FINRA Rule 5122(b)(2).

<sup>5</sup> Rule 4512(c) defines “institutional account” as the account of:  
(1) a bank, savings and loan association, insurance company or registered investment company;  
(2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act or with a state securities commission (or any agency or office performing like functions); or  
(3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million.

<sup>6</sup> See 15 U.S.C. 80a-2(a)(51).

<sup>7</sup> See 17 CFR 230.144A(a)(1).

<sup>8</sup> Rule 5122 exempts the following member private offerings:  
(1) offerings sold solely to:  
(A) institutional accounts, as defined in Rule 4512(c);  
(B) qualified purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act;  
(C) qualified institutional buyers, as defined in Securities Act Rule 144A;  
(D) investment companies, as defined in Section 3 of the Investment Company Act;

Rule 5123 requires members to file with FINRA any PPM, term sheet or other offering document, including any material amended versions thereof, used in connection with a private placement of securities within 15 calendar days of the date of first sale.

Rule 5123 exempts private placements that are filed under other FINRA Corporate Financing Rules, as well as most of the same categories of private placements that are

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(E) an entity composed exclusively of qualified institutional buyers, as defined in Securities Act Rule 144A; and

(F) banks, as defined in Section 3(a)(2) of the Securities Act;

(2) offerings of exempted securities, as defined in Section 3(a)(12) of the Exchange Act;

(3) offerings made pursuant to Securities Act Rule 144A or Regulation S;

(4) offerings in which a member acts primarily in a wholesaling capacity (i.e., it intends, as evidenced by a selling agreement, to sell through its affiliate broker-dealers, less than 20% of the securities in the offering);

(5) offerings of exempt securities with short term maturities under Section 3(a)(3) of the Securities Act;

(6) offerings of subordinated loans under Exchange Act Rule 15c3-1, Appendix D (see NASD Notice to Members 02-32 (June 2002));

(7) offerings of “variable contracts”, as defined in FINRA Rule 2320(b);

(8) offerings of modified guaranteed annuity contracts and modified guaranteed life insurance policies, as referenced in FINRA Rule 5110(h)(2)(D);

(9) offerings of unregistered investment grade rated debt and preferred securities;

(10) offerings to employees and affiliates of the issuer or its control entities;

(11) offerings of securities issued in conversions, stock splits and restructuring transactions that are executed by an already existing investor without the need for additional consideration or investments on the part of the investor;

(12) offerings of securities of a commodity pool operated by a commodity pool operator, as defined under Section 1a(5) of the Commodity Exchange Act;

(13) offerings of equity and credit derivatives, including OTC options; provided that the derivative is not based principally on the member or any of its control entities; and

(14) offerings filed with Corp Fin under FINRA Rules 2310, 5110 or Rule 5121.

exempt from filing under Rule 5122.<sup>9</sup> As a result of these exemptions, both rules apply predominately to private placements sold to retail investors.

FINRA received 2,509 unique Rule 5122 and 5123 filings in 2019. FINRA uses analytics to conduct a risk-based review for each filing. This analysis of an offering's risk to investors and its ability to identify potential rule violations and other potential problems begins with the information and documents submitted. Members that sell private placements may use a PPM or term sheet alone, or may use a variety of other offering documents in addition to, or instead of, a PPM or term sheet.

Because members use a wide variety of materials, Rules 5122 and 5123 do not enumerate the types of information that might be considered "offering documents." FINRA has stated previously that an example of "other offering document" is "[a]ny other type of document that sets forth the terms of the offering."<sup>10</sup> The terms of an offering include facts such as the amount of proceeds that the issuer intends to raise, the type of security, descriptions or illustrations of the intended use of proceeds, and explanations of tax benefits or other information that would be relevant to an investor when deciding whether to make an investment.

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<sup>9</sup> See FINRA Rule 5123(b); see also note 8, *supra*. In addition to the exemptions contained in Rule 5122, Rule 5123(b) exempts offerings sold by the member or person associated with the member to (a) employees and affiliates, as defined in Rule 5121, of the issuer; (b) knowledgeable employees as defined in Investment Company Act Rule 3c-5; (c) eligible contract participants, as defined in Section 3(a)(65) of the Exchange Act; and (d) accredited investors described in Securities Act Rule 501(a)(1), (2), (3), and (7); and exempts business combination transactions as defined in Securities Act Rule 165(f), and standardized options as defined in Securities Act Rule 238.

<sup>10</sup> See "Frequently Asked Questions (FAQ) About Private Placements," Question #10, available on [www.finra.org](http://www.finra.org).

While Rules 5122 and 5123 do not require retail communications governed by Rule 2210 (Communications with the Public) to be filed, many members file these communications with their required documents.<sup>11</sup> Examples of these retail communications can include web pages that promote the offering, slide presentations, pitch decks, one-page “teasers,” fact sheets, sales brochures, executive summaries, and investor packets. Corp Fin often forwards these retail communications to FINRA’s Advertising Regulation Department (“AdReg”) for review.

Corp Fin staff triages the filings it receives under Rules 5122 and 5123 using a variety of criteria and selects a subset for further analysis and review based on the relative risk of the offering. In some cases, FINRA opens investigations of particular offerings, which may lead to follow-up examinations by Member Supervision staff, and potentially, referrals to the Department of Enforcement.

#### Advertising Regulation Review of Private Placement Retail Communications

In addition to reviewing private placement retail communications that are filed under Rules 5122 and 5123 and referred by Corp Fin, AdReg reviews private placement retail communications that it receives through one of four other channels: (i) new member and voluntary filings with AdReg; (ii) referrals from the Member Supervision examination program and other surveillance groups; (iii) AdReg spot checks; and (iv) assistance in Enforcement cases.

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<sup>11</sup> See Regulatory Notice 09-27 (May 2009), which announced SEC approval of Rule 5122, stated that the rule imposes no additional requirements regarding the filing of advertisements or sales materials. However, as noted, many firms do in fact file retail communications concerning private placements under Rules 5122 and 5123.

AdReg has observed that retail communications that have been directly filed by new members<sup>12</sup> or voluntarily with AdReg for private placements raise more compliance issues than those for other products. Between January 1, 2017, and March 31, 2020, AdReg reviewed 1,726 new member and voluntary filings of private placement retail communications. Of these filings, 41% required revisions to comply with applicable standards, and 4% were so noncompliant with the rules that FINRA issued “do not use” (DNU) review letters. In comparison, during this same period, only 8% of overall AdReg filings reviewed required revisions, and only 0.1% received a DNU letter.<sup>13</sup>

In 2018, AdReg conducted a spot check of the private placement retail communications provided to Corp Fin in connection with filings under Rules 5122 and 5123 during the second and third quarters of 2018. The review revealed significant and pervasive violations of Rule 2210; overall, 806 of the 1,062 retail communications reviewed (76%) did not comply with Rule 2210.

The most common violation was the inclusion of prohibited projections of performance or unreasonable forecasts, e.g., “Return 4-6x invested capital net of fees” and “Management projects a \$100 million revenue stream can be built in 5 years.”

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<sup>12</sup> Rule 2210(c)(1)(A) requires new members to file all widely-distributed retail communications (such as publicly available websites) that promote products or services of the firm during the first year after the member’s broker-dealer membership with FINRA is declared effective.

<sup>13</sup> During the same period, AdReg analyzed 1,328 private placement retail communications that were referred from Corp Fin, Member Supervision, or other FINRA departments. Seventy-one percent (71%) of these communications required revisions to comply with applicable standards and 13% resulted in a DNU letter. In contrast, 66% of all communications referred by other FINRA staff were determined to require revisions and 4% resulted in a DNU letter.

Numerous others contained false or misleading statements, e.g., “Safety of Principle” [*sic*] and “UTILIZES AI & MACHINE LEARNING TECHNOLOGY SIMILAR TO THAT USED BY ONLINE GIANTS SUCH AS FACEBOOK, NETFLIX, AMAZON AND STITCH FIX.” Another common issue was the failure to balance promotional content with the key risks associated with the investment, such as a real estate offering touting the benefit of purchasing properties leased by “investment grade” tenants without discussing that such holdings do not assure a profit or protect against loss. Others failed to disclose general risks, such as the speculative nature of the securities and the lack of liquidity of the investment.

Private placement retail communications also feature prominently in FINRA’s Enforcement program. Since January 1, 2014, FINRA has initiated 49 disciplinary actions related to non-compliant retail communications concerning private placements. This number represents 21% of all actions involving private placements.

#### Filing Proposal

Given the comparatively high rate of non-compliance of private placement retail communications, and the increased risk of investor harm associated with those communications, FINRA proposes to amend Rules 5122 and 5123 to require such retail communications to be filed, in addition to the currently required PPMs, term sheets, and other offering documents.

Rules 5122 and 5123 focus on the private placements that raise the greatest concerns—those sold to retail investors, whether or not accredited. FINRA proposes to limit the new filing requirement to the same offerings; it would not apply to any offerings

that are currently exempt from filing.<sup>14</sup> A member would be required to file with FINRA such retail communications no later than the date on which a filing is required under Rules 5122 and 5123.<sup>15</sup> The proposal would not require members to file private placement retail communications for offerings that are not subject to the filing requirements in Rules 5122 or 5123, such as sales exclusively to institutional accounts. Moreover, because Rules 5122 and 5123 do not impose any filing fees, members would not be subject to higher fees because of this additional filing requirement.

FINRA anticipates that members would be able to file most retail communications at the same time and in the same manner that they file their PPMs, term sheets, and other offering documents. The rules' requirements that material amendments to offering documents must be filed also would apply to retail communications.

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 180 days see publication of the Regulatory Notice announcing Commission approval.

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<sup>14</sup> See supra notes 8 and 9.

<sup>15</sup> As discussed above, Rule 5122 requires a member subject to the rule to file the PPM, term sheet or other offering document with FINRA at or no later than the first time the document is provided to a prospective investor. Any amendments or exhibits to such offering documents also must be filed with FINRA within 10 days of being provided to any investor or prospective investor. See Rule 5122(b)(2). Rule 5123 requires a member subject to the rule to file with FINRA the PPM, term sheet or other offering document, including any materially amended versions thereof, used in connection with the sale of securities covered by the rule within 15 calendar days of the date of first sale, or notify FINRA that no such offering documents were used. See Rule 5123(a).



2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>16</sup> 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. FINRA believes that requiring the filing of retail communications under Rules 5122 and 5123 will improve members' compliance and understanding of the application of FINRA's communications with the public rules and reduce the likelihood that retail investors would receive false or misleading sales material for private placements.<sup>17</sup>

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

Economic Impact Assessment

FINRA has undertaken an economic impact assessment, as set forth below, to analyze the regulatory need for the proposed rule change, its potential economic impacts, including anticipated costs, benefits, and competitive effects, relative to the current baseline, and the alternatives FINRA considered in assessing how best to meet FINRA's regulatory objectives.

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<sup>16</sup> 15 U.S.C. 78o-3(b)(6).

<sup>17</sup> FINRA recently issued a Regulatory Notice providing guidance under Rule 2210 to firms that distribute retail communications concerning private placements. See Regulatory Notice 20-21 (July 1, 2020).

Regulatory Need

As discussed above, FINRA has seen significant problems with the retail communications that have been voluntarily filed under Rules 5122 and 5123. In addition, as noted above, the 2018 spot check revealed that 76% of retail communications filed under Rules 5122 and 5123 during the spot check review period involved significant violations of Rule 2210.<sup>18</sup> It is possible that significant violations may be even more prevalent among retail communications that have not been voluntarily filed or reviewed. Moreover, high-risk retail communications concerning private placements feature prominently in FINRA's Enforcement program.<sup>19</sup> These communications often present false or misleading information regarding the underlying offering, which could result in significant losses to investors and could undermine public trust in the private placement markets. The proposed amendments, therefore, are intended to promote investor protection and market integrity by expanding FINRA's oversight of high-risk retail communications concerning private placements.

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<sup>18</sup> Among the retail communications reviewed, 45% contained prohibited projections or unreasonable forecasts; 44.6% failed to provide a sound basis to evaluate the facts with respect to the offering in that the benefits articulated in the marketing materials were not balanced by key specific risks associated with an investment or the issuer; 39.9% failed to adequately disclose the general risks associated with private placement investments; 21.8% contained readily apparent false or misleading statements or claims; and 7.4% contained misleading references to FINRA, other regulators, or the benefits of regulation generally.

<sup>19</sup> As mentioned earlier, retail communications concerning private placements resulted in 49 FINRA disciplinary actions since January 2014, representing 21% of FINRA's disciplinary actions involving private placements during the period.

Economic Baseline

The economic baseline includes the current regulation of retail communications under Rule 2210 and current regulation of specified private placements under Rules 5122 and 5123. All retail communications are required to comply with the general, fair and balanced standards detailed in Rule 2210; however, Rule 2210 generally does not require members to file with FINRA the materials they use to communicate with retail investors concerning private placements. Under Rules 5122 and 5123, members are required to file with FINRA any PPM, term sheet, or other offering document used in connection with specified private placements, although these rules do not currently require retail communications governed by Rule 2210 to be filed. Therefore, firms currently have no regulatory obligation to submit these communications for review by FINRA.

The economic baseline also includes members' existing practices under Rules 2210, 5122 and 5123. Currently, some members submit retail communications as part of their Rules 5122 and 5123 private placement filings with Corp Fin; some members file these communications through AdReg's filings review program under Rule 2210 either voluntarily or as new members; and some members submit these communications to both or neither of these departments.

As discussed above, upon receiving filings under Rules 5122 and 5123, Corp Fin triages the filings to select a subset for further review based on the relative risk of the offering. Corp Fin notifies AdReg when it receives retail communications in connection with the higher-risk offerings it assigns for reviews. AdReg then conducts its own triage program based on the relative risk of these retail communications.

Once high-risk retail communications are identified, AdReg requests Corp Fin to refer them to AdReg and opens a complex review matter to assess whether the communications meet applicable communication standards. If apparent rule violations are identified, AdReg will, as needed, provide an analysis for an existing Corp Fin investigation or contact the member firm to explain the concerns, ask the firm to remediate the communications, and determine the extent of the communications' use. AdReg may resolve the matter with informal disciplinary action or, if severe violations are identified, may refer the matter to FINRA's Department of Enforcement.<sup>20</sup>

The existing regulatory procedure concerning private placement retail communications that are filed with AdReg under Rule 2210 voluntarily or by new members adopts a different approach from the above. AdReg conducts a review in response to each retail communication filing and provides a review letter indicating whether the communication appears to be consistent with the applicable standards, and if not, the bases for this determination.<sup>21</sup>

FINRA has collected information for assessing the specified private placement market under Rules 5122 and 5123. On average, FINRA receives approximately 2,400 new offering filings annually, with approximately 10-15% of the filings representing a duplicate filing by separate firms with respect to the same offering. As a reference, the Regulation D data published by the SEC's Division of Economic and Risk Analysis in

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<sup>20</sup> A similar procedure is followed when AdReg receives referrals from the Member Supervision examination program or other surveillance groups.

<sup>21</sup> Unlike Corp Fin's private placement review program under Rules 5122 and 5123, filings through AdReg's filings review program under Rule 2210 are subject to filing fees.

August 2018 provided that approximately 20,000 new offering filings on average were submitted via EDGAR each year from 2015 to 2017. Of this total, roughly 4,000 (or 20%) of the new offerings that SEC identified involved “intermediaries” such as brokers or finders, some of which may not be FINRA members. Accordingly, FINRA’s private placement review program under Rules 5122 and 5123 accounts for approximately half of the new offerings filed with the SEC that involve intermediaries and approximately 10% of all new offering filings annually.

To assess how likely the specified private placements use retail communications, FINRA has analyzed information pertaining to 1,327 offerings filed with Corp Fin under Rules 5122 and 5123 during the second and third quarters of 2018.<sup>22</sup> Approximately 781 (or 59%) of the offerings did not include retail communications as part of the filing. There were 1,062 retail communications submitted by 132 members for the remaining 546 offerings.<sup>23</sup> The average (maximum) number of retail communications submitted per member among these offerings was eight (260), respectively. The average (maximum) number of retail communications per offering was approximately two (23) retail communications.

To further assess the existing regulatory procedure under Rules 5122 and 5123, FINRA collected review information regarding the 708 private placement filings with

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<sup>22</sup> The information was collected by AdReg in the 2018 spot check. There were 2,269 filings inclusive of amendments by 309 member firms related to the 1,327 offerings. Among them, 1,208 had projected proceeds totaling \$37.6B while projected proceeds were unknown for other offerings.

<sup>23</sup> Among the 546 offerings that included retail communications, 524 of them had projected proceeds totaling \$10.8B with projected proceeds unknown for the remaining offerings.

Corp Fin over the period February 1, 2020 to April 17, 2020.<sup>24</sup> Corp Fin identified 274 (or 38.7%) of filings that contained retail communications during this period. Among these 274 filings, 37 (or 13.5%) were deemed by Corp Fin to be high risk. AdReg triaged the retail communications in these 37 filings and determined that 14 represented likely significant violations of Rule 2210 and opened 14 complex review matters. These 14 matters represented 5% of all filings containing retail communications under Rules 5122 and 5123 during this period.<sup>25</sup>

#### Economic Impacts

The proposed rule change would directly impact members that distribute retail communications concerning specified private placements by requiring them to submit these communications to Corp Fin at the time they file the PPM, term sheet, or other offering document. Such an impact would be more pronounced for members that have not been voluntarily filing private placement retail communications with Corp Fin or AdReg. FINRA anticipates a considerable increase in the number of retail communications filed under Rules 5122 and 5123 as a result of the proposal. As was found during the 2018 spot check, approximately 41% of the offerings included retail communications voluntarily submitted concerning these offerings. If each offering is associated with an average of two retail communications, then the number of retail

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<sup>24</sup> This sample is different from the previous sample of the 2018 spot check: it is based on the most recent period for which FINRA has reliable data on its triage and review process.

<sup>25</sup> FINRA recognizes that the percentage of retail communications selected for complex review at any point in time (including after the proposed rule change) may deviate from 5%, as the time period used for deriving the estimate might be too short to draw reliable inferences.

communications could be increased by 3,124 retail communications annually, totaling 5,308 retail communications per year.

The estimate of two retail communications per offering may overstate or understate the true amount. Note that the average of two retail communications per offering found during the spot check may understate the true average if members did not voluntarily file all retail communications associated with these offerings. Alternatively, the average retail communications per offering could be lower than two if there were many offerings that did not submit any retail communications because they did not distribute any such communications.

In developing the proposal, FINRA staff does not expect it to have a significant impact on AdReg's existing filings review program. Members will continue to have the option (but not the obligation) to file these communications through AdReg's filings review program following the proposal.<sup>26</sup>

The primary benefit of the proposed rule change would arise from FINRA's enhanced insight into and oversight of retail communications concerning high-risk private placements.<sup>27</sup> Specifically, the proposed amendments would enable FINRA to review all retail communications concerning the specified private placements through its

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<sup>26</sup> FINRA believes that some members will continue to have incentives to file voluntarily retail communications through AdReg's filings review program following the proposed amendments. For instance, members and related parties may still benefit from a review letter indicating the material is consistent with applicable standards.

<sup>27</sup> FINRA recognizes that the proposal would not likely impact FINRA's oversight of low-risk offerings or low-risk retail communications as defined by the current triage process.

triage program and if warranted, open cases for complex review, thereby extending FINRA's ability to potentially uncover significant violations of Rule 2210. In addition, retail communications that have not been filed voluntarily with Corp Fin or AdReg may have contained violations of greater severity or presented novel regulatory issues unknown to FINRA. By allowing access to retail communications concerning private placements from all filing members, the proposal would help FINRA staff understand the scope and severity of existing issues in a more accurate and efficient manner, which would further enhance FINRA's surveillance and enforcement program.<sup>28</sup>

The proposal likely would increase members' incentives to distribute retail communications concerning private placements that are fair and balanced and deter them from presenting false or misleading information that may cause investor harm. The proposed change may also likely increase issuers' incentives to disclose the risks of private placements in a fair and balanced manner in connection with retail communications, thereby enhancing the capabilities of investors and other related parties to assess these risks as part of their investment decisions.

FINRA believes that greater regulatory oversight, together with changes in members' and issuers' incentives, would help promote greater investor protection and public trust in the private placement markets. The benefit from enhanced incentives and regulatory oversight would more likely accrue with respect to members that frequently file private placements that include retail communications. FINRA recognizes that the

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<sup>28</sup> Although FINRA does not anticipate immediate changes to its existing triage programs, the additional knowledge that FINRA would acquire following the proposal could potentially help FINRA refine its triage programs in the long run.



proposal's investor protection benefits may be limited given that members are required to file private placement offerings within 15 calendar days of the date of first sale under Rule 5123. (Rule 5122 requires member private offerings to be filed at or prior to the date of first sale.) The proposal's investor protection benefits also may vary depending on how long the Corp Fin triage process takes and how quickly AdReg triages and reviews the communications and the available remedying tools.

FINRA believes that the proposal would impose a minimal increase in direct costs to members that have not already been voluntarily filing private placement retail communications with Corp Fin. Specifically, the proposal would require these members to file any additional retail communications that promote the offering at the time they file the PPM or term sheet. Members also would be required to file retail communications subsequent to the initial filing if they distribute new retail communications promoting the offering or make material changes to any previously filed retail communications. FINRA believes such increases in direct costs would be minimal as Rules 5122 and 5123 do not impose filing fees, and most filing members are already familiar with the Corp Fin filing system.<sup>29</sup>

FINRA recognizes that members that distribute high-risk retail communications concerning private placements may be subject to additional regulatory review by FINRA

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<sup>29</sup> FINRA believes that increases in direct costs may be even lower for members that have been voluntarily filing private placement retail communications with AdReg because they may already be familiar with the applicable standards under Rule 2210. These members will also have the option to file private placement retail communications only with Corp Fin following the rule proposal. This option could lead to a reduction in the filing fee for these members. However, should firms choose to file only with Corp Fin, there will not be a guaranteed review or review letter from FINRA.

as FINRA anticipates an expansion in its complex review program following the proposal.<sup>30</sup> FINRA believes the overall increase in regulatory costs and uncertainty to members associated with the additional review would likely be low because only a very small percentage of retail communications with the highest risk profile would be subject to the review. FINRA does not expect increases in direct and indirect costs will deter firm entry or private placement offerings or result in any significant burden on competition that is not necessary or appropriate in furtherance of the purpose of the Exchange Act.

#### Alternative Considered

FINRA considered proposing an amendment to Rule 2210 that would require members to submit private placement retail communications through AdReg's filings review program. AdReg would review all private placement retail communications filed under the alternative proposal. The alternative, therefore, would enhance FINRA's oversight of both high-risk and low-risk private placement retail communications, leading to significant improvement in members' compliance and understanding of applicable rules and greater benefit from market integrity and investor protection.

The alternative, however, would impose higher costs on members for several reasons. First, members would be subject to filing fees under Rule 2210, which would not apply to filings made under Rules 5122 or 5123. Second, members would have to file retail communications and offering documents separately with AdReg and Corp Fin

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<sup>30</sup> FINRA recognizes that misidentifications of high-risk matters (i.e., subjecting members that are less likely to pose a high risk to investors to the additional complex review) may induce unintended indirect costs on these members.

using different filing systems. Third, all filing members would face additional regulatory costs and uncertainty while the review is pending.<sup>31</sup> FINRA is also concerned that the alternative approach may divert limited regulatory resources from high-risk matters. Overall, FINRA believes that the current proposal would build on the risk-based regulatory approach for private placements thereby promoting regulatory consistency and impose lower costs to members than the alternative FINRA has considered.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

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<sup>31</sup> The filing requirements under Rules 5122 and 5123 are notice filings only and members do not wait for approval from FINRA in connection with a private placement. However, if FINRA asks questions of the member in response to its filing, the member may become concerned that there may be a potential compliance issue with the private placement or related documents. Similarly, the filing requirement under Rule 2210 may not have required the member to be issued a review letter from FINRA before using a retail communication. However, some members may wait until the letter is received before using such communication.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2020-038 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2020-038. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3

p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2020-038 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>32</sup>

Jill M. Peterson  
Assistant Secretary

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<sup>32</sup> 17 CFR 200.30-3(a)(12).

**EXHIBIT 5**

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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**5100. SECURITIES OFFERINGS, UNDERWRITING AND COMPENSATION**

**5120. OFFERINGS OF MEMBERS' SECURITIES**

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**5122. Private Placements of Securities Issued by Members**

(a) No Change.

**(b) Requirements**

No member or associated person may offer or sell any security in a Member

Private Offering unless the following conditions have been met:

(1) No Change.

**(2) Filing Requirements**

A member must file the private placement memorandum, term sheet, or [such] other offering document, and any retail communication (as defined under Rule 2210) concerning the member private offering with the Corporate Financing Department at or prior to the first time the document or retail communication is provided to any prospective investor. Any amendment(s) or exhibit(s) to the private placement memorandum, term sheet, [or] other offering document or retail communication also must be filed with the Department within ten days of being provided to any investor or prospective investor.

(3) No Change.

(c) through (e) No Change.

••• **Supplementary Material:** -----

No Change.

**5123. Private Placements of Securities**

**(a) Filing Requirements**

Each member that sells a security in a non-public offering in reliance on an available exemption from registration under the Securities Act (“private placement”) must: (i) submit to FINRA, or have submitted on its behalf by a designated member, a copy of any private placement memorandum, term sheet or other offering document, and any retail communication (as defined in Rule 2210) concerning the private placement, including any materially amended versions thereof, used in connection with such sale within 15 calendar days of the date of first sale; or (ii) notify FINRA that no such offering documents or retail communications were used. Members must provide FINRA with the required documents, retail communications, or notification and related information, if known, by filing an electronic form in the manner prescribed by FINRA.

(b) through (d) No Change.

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