PRYOR CASHMAN LLP

LEGAL UPDATE

February 2011 *By: Stephen M. Goodman*

FINRA SEEKS TO MONITOR BROKER COMPENSATION IN NON-MEMBER PRIVATE OFFERINGS THROUGH PRE-FILING REQUIREMENT

Recent efforts by the Securities and Exchange Commission (the "SEC") to rein in unregistered brokers engaged in private placement activity[1] have been complemented by a shift in the approach of the Financial Industry Regulatory Association ("FINRA") toward such private offerings. In public offerings, FINRA and its predecessors have for many years required that member firms submit their compensation arrangements for approval prior to commencing selling efforts. Now FINRA is proposing to amend its Rule 5122 to require for the first time that private offering documents for non-member issuers be filed in advance so that FINRA can monitor broker compensation as well as certain other disclosures.

FINRA first adopted Rule 5122 (the "Rule") in June 2009, imposing certain disclosure and pre-offering filing requirements on private offerings of the securities of a member firm or a "control entity" of that firm.[2] Now through amendments to the Rule proposed in Regulatory Notice 11-04, issued January 11, 2011 (the "Notice"), FINRA seeks to extend similar requirements to many additional types of private placements by issuers of all types (including PIPEs[3] and other offerings, even if limited to accredited investors). In brief, the amendments propose to restrict member firms from participating in these other types of private placements unless an offering document containing certain disclosures is first filed with FINRA. As discussed below, the new requirements raise some issues which are not present when a member is affiliated with the issuer but which may present some significant uncertainties when a member is dealing with an issuer at arms-length.

[1] In September 2008 the Securities and Exchange Commission ("SEC") amended Form D to require (among other things) that issuers identify anyone receiving sales compensation in connection with an offering and their Central Registration Depositary (CRD) number. Finders and other unregistered brokers do not have such a number. See SEC Release No. 33-8891(February 20, 2008, Effective September 15, 2008). In May 2010 the SEC issued a no-action letter that reiterates its long-held position that any person who receives compensation in connection with an offering based on the amount raised must register as a broker under the Securities Exchange Act of 1934, as amended, even if that person's only role is to make introductions to potential investors. *Brumberg, Mackey & Wall, P.L.C.,* SEC No Action Letter (May 17, 2010), available at http://www.sec.gov/divisions/marketreg/mr-noaction/2010/brumbergmackey051710.pdf. See *Vanishing Breed: The Narrowing Opportunities for Unregistered Finders* by Stephen M. Goodman, BNA Securities Law & Regulation Report, 42 SRLR 1911 (October 11, 2010).

[2] FINRA Regulatory Notice 09-27 (effective June 17, 2009). FINRA acknowledged in the notice regarding adoption of the final rule that the new requirements had previously applied only to public offerings of securities by members. (Emphasis added.)

[3] Private investments in public equity. See "Frequently Asked Questions about PIPEs", available at http://www.sec.gov/info/smallbus/gbfor25_2006/pinedo_tanenbaum_pipefaq.pdf.

BACKGROUND

Citing abuses regarding broker compensation and the use of proceeds in private offerings of securities issued by FINRA members or their "control entities",[4] FINRA adopted Rule 5122, which imposed three new requirements on member firms conducting such private offerings (referred to as "member private offerings" or "MPOs"). First, the Rule requires such a member to provide investors with an offering document that discloses the intended use of offering proceeds and that details offering expenses and selling compensation. Second, the member must commit that at least 85 percent of the offering proceeds in an MPO will be used for business purposes.[5] Finally, to monitor compliance, the Rule requires member-brokers to pre-file the offering document with FINRA "to allow FINRA staff to identify those offering documents that are deficient 'on their face' from the other requirements of the Rule."[6]

The proposed amendments to the Rule seek to limit member participation in many private placements[7] by issuers who are not themselves members or "control entities" unless the offering documents comply with substantially the same requirements.[8]

THE PROPOSED AMENDMENTS

Substantive Disclosures Under the proposed amendments (as under the current Rule), the participating member would have to ensure that the offering document includes disclosures regarding the intended use of the offering proceeds, as well as the offering expenses and the amount and type of compensation that will be paid to "participating" broker-dealers and associated persons. If applicable, because the amendments would cover placements by non-member issuers, the amendments would also seek disclosure of the nature of any affiliation between the issuer and any participating broker-dealer.[9]

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[4] *See* , Franklin Ross, Inc., summarized in NASD Notice Disciplinary Actions, p. 1 (May 2006); Capital Growth Financial, LLC, summarized in NASD Notice Disciplinary Actions, p. 1 (April 2006); Craig & Associates, Disciplinary Actions, p. D6 (October 2005).

[5] In calculating the amount of proceeds "used for business purposes," offering costs, discounts, commissions and any other cash or non-cash sales incentives are excluded. The use of the offering proceeds also must be consistent with the description of their use under the Rule. FINRA Rule 5122(b)(3).

[6] Unlike public offerings, according to Regulatory Notice 09-27, "FINRA staff will not review the offering and issue a 'no-objections' letter before a member may commence the offering." However, the document may still form the basis for referrals to FINRA's Enforcement Department if the terms or disclosure are deemed violative of Rule 5122 or any other provision of the federal securities laws or FINRA's rules.

[7] The rule (both before and after the amendments) excludes certain private offerings from coverage, such as (among others) offerings sold to qualified institutional buyers (as defined in Securities Act Rule 144A), investment companies or banks; offerings of exempt securities as defined in Section 3(a)(12) of the Securities Act; and offerings under Rule 144A and Regulation S. FINRA Rule 5122(c). Notably, private offerings under Section 4(2) of the Securities Act or Regulation D are not excluded from coverage.

[8] Noting that the current rule does not address private placements in which the issuer is neither a broker-dealer nor its control entity, Regulatory Notice 11-04 indicates that FINRA received approximately 300 filings pursuant to Rule 5122 during the first year that the rule was in effect, while it cites an SEC report that noted that in 2008 there were over 20,000 Form D filings. The Notice also points out that, based on FINRA staff's review of a sample of filings made in 2010, approximately 15 percent of them disclosed broker-dealer participation in a particular offering.

[9] Rule 5122(b)(1)(A). The current Rule's requirement to disclose information regarding "control entities" of the member would be replaced in the proposed amendments with disclosures regarding "affiliates" of the member. Although the amendments include a common definition of "affiliate" (i.e., a company that controls, is controlled by or is under common control with the member), the term "control" would change under the amendments to the meaning specified in FINRA Rule 5121 (Formerly NASD Rule 2720). Rule 5121 provides for control if there is beneficial ownership of as little as 10 percent of the common equity, preferred equity or subordinated debt of an entity, the right to 10 percent or more of the

Participating in an Offering. The proposed amendments would require compliance by any member or associated person that "participates" in a private offering. "Participation" would have the meaning specified in FINRA Rule 5110 – the rule governing underwriting arrangements in public offerings.[10] Under FINRA Rule 5110(a)(5), participation in an offering includes "preparation of the offering or other documents, participation in the distribution of the offering on an underwritten, non-underwritten, or any other basis, furnishing of customer and/or broker lists for solicitation, or participation in any advisory or consulting capacity to the issuer related to the offering." Thus, any member firm that provides consulting services or other support for an offering, even if not acting as a placement agent, would have (or at least share) responsibility for seeing that the requirements of Rule 5122 are met.

Preparation and Filing of an Offering Document. As with MPOs under the current Rule, a member participating in an offering must ensure that an offering document containing the requisite disclosures is filed with FINRA "at or prior to the first time the document is provided to any prospective investor."[11] As also specified in the current Rule, if the offering does not have a private placement memorandum or term sheet, the proposed amendments obligate the member to prepare an offering document that contains the required disclosures and to provide that document to each prospective investor.[12]

In its current form, the Rule only covers offerings where the member firm and the issuer are either the same entity or entities under common control. In such situations, the member and the issuer (even if a different entity) share the consequences if the disclosures fail to comply with the Rule. However, where the issuer and the member are not affiliated, the member would seem to bear all of the consequences of non-compliance, since it has no means to assure itself as to whether the disclosures are complete and accurate.

Of course a member could get an affirmative agreement from the issuer that its offering document will comply with the disclosure requirements of the Rule, and an indemnification against the consequences of breach. But a member who participates in an offering by an unaffiliated issuer clearly could risk a FINRA enforcement action for breach of the Rule (which the issuer would not) if the issuer's broker compensation and use of proceeds disclosures were found to be less than complete.

This risk is magnified if more than one member has "participated" in the placement. For example, the issuer may have engaged one member as a consultant, received an introduction to an investor from another and use yet a third as the placement agent. Potentially, each of these members could be held responsible if the issuer's offering document fails to disclose the role which each of them played and how much each of them has been compensated.[13] As a result, the amended Rule may compel a participating member to conduct due diligence to verify whether other members are involved.

Use of Offering Proceeds. As with the current Rule, the amendments also require that at least 85% of the offering proceeds raised must be used for the business purposes specified in the

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profits or losses of a partnership or the power to direct or cause the direction of the management or policies of an entity.

[10] Proposed FINRA Rule 5122(a)(3).

[11] Rule 5122(b)(1)(A).

[12] Rule 5122(b)(1)(B).

[13] For similar reasons, the amended Rule seems impractical to the extent that it seeks to impose on "participating" members the obligation to prepare the necessary offering document for filing if an unaffiliated issuer does not do it.

offering document under the Rule.[14] Even more than with the disclosure obligations, where the issuer is not related to the member, neither the member nor FINRA has any means to monitor or compel proper application of the proceeds by the issuer. Nor does the proposed Rule offer any indication regarding whether a member in fact would have any responsibility for monitoring compliance. To discharge such an obligation, a member would need an undertaking from the issuer not only to apply the proceeds in accordance with the disclosures in the offering document, but also to provide the member with periodic reports of how the proceeds were applied. The proposed Rule does not indicate what action the member might take against the issuer if the undertaking is breached. Thus, it remains unclear what the scope of a participating member's risk would be if the issuer failed to properly apply the offering proceeds.

Post-Filing Review by FINRA. Neither the current version of the Rule nor the amendments require that compensation arrangements must be approved prior to the commencement of selling efforts, as they must be under Rule 5110 in connection with a public offering.[15] Instead, it states that "the offering may proceed while FINRA staff reviews the offering document."[16]

Unfortunately for members, the Notice also states that "if FINRA staff determines that an offering document presents an apparent investor protection issue, the responsible member should expect FINRA staff to contact the broker-dealer concerning the matter, whether or not the offering has already commenced." Members may be reluctant to commence promotion of an offering if FINRA may subsequently raise questions regarding the accuracy and completeness of disclosures relating to member compensation and the use of proceeds.

RECOMMENDATIONS

Comments regarding the proposed Rule must be received by March 14, 2011. Given the number of transactions that may be impacted by the proposed changes, it seems likely that other issues will emerge in addition to those identified above. We recommend that management of member firms consider providing FINRA with comments regarding the changes that the Rule might require in their normal practices, especially active PIPE or private placement practices. Please contact Pryor Cashman if we can be of assistance.

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The foregoing is intended to summarize FINRA's proposed amendments to Rule 5122, and does not constitute legal advice. Please contact the Pryor Cashman attorney with whom you work with any questions you may have. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Stephen M. Goodman at (212) 326-0146.

[14] Rule 5122(b)(3).

[15] Rule 5110(b)(5).

[16] The Notice is clear that the amended rule would not require a member to refrain from selling efforts pending a "no objections" letter prior to the commencement of selling efforts, as it would in the public offering.

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Stephen M. Goodman is co-head of the Mergers and Acquisitions Practice at Pryor Cashman LLP. He has extensive experience representing technology-based companies in public offerings; private placements; limited liability company, partnership and joint venture agreements; and complex arrangements for the acquisition, sale, development and commercialization of patents, copyrights and trademarks, in particular for drug compounds and formulations, software and other technology.

Mr. Goodman has also written on topics ranging from issues confronting unregistered finders to raising seed capital for entrepreneurial companies and has lectured on various aspects of pharmaceutical/biotech collaboration agreements.

Mr. Goodman has been responsible for negotiating and documenting the following representative transactions:

- On behalf of the placement agent, a PIPE transaction for a publicly-traded Chinese company in the catering and restaurant sales businesses primarily in the People's Republic of China
- On behalf of a multi-national professional publishing company, acquisitions of the stock or assets of more than thirty targets, in transactions ranging in value up to $1 billion, including acquisitions involving counsel in multiple jurisdictions, auction transactions and several involving friendly tender offers for the stock of publicly-traded companies
- On behalf of a development stage biotechnology company, a private financing of $8.4 million to advance a client's two lead drug programs and a "double-dummy" reverse merger with a second biotechnology company, creating a single company with multiple drug programs which was purchased by a public pharmaceutical company for more than $100 million
- On behalf of an early pioneer in internet music delivery, two private preferred equity financings, the second led by a major hedge fund
- On behalf of a public company in the field of monoclonal antibody research, an initial and a secondary public offering

Mr. Goodman is a 1977 graduate of New York University School of Law, where he was Order of the Coif and Articles Editor of the Annual Survey of American Law.