NEW FINRA RULE ON MEMBER PRIVATE OFFERINGS

The Financial Industry Regulatory Authority, Inc. ("FINRA") has published Regulatory Notice 09-27 (the "Notice") providing the effective date of its new Rule 5122, which regulates private placements of securities issued by FINRA member firms or "control entities" of such firms, known as Member Private Offerings.[1] Rule 5122 will be effective as of June 17, 2009, but will not apply retroactively to any offerings that have already commenced selling efforts as of that date.

Requirements of Rule 5122

New Rule 5122 requires a FINRA member engaging in a private placement of unregistered securities issued by the FINRA member or a control entity of the FINRA member to:

(1) disclose to investors the intended use of offering proceeds and offering expenses in the form of an offering document, such as a term sheet or PPM,

(2) file such offering document with the FINRA Corporate Financing Department prior to or at the time it is provided to any investor,[2] and

(3) commit that at least 85 percent of the offering proceeds will be used for business purposes, which shall not include offering costs, discounts, commissions and any other cash or non-cash sales incentives.

Scope of Rule 5122

A Member Private Offering ("MPO") is defined as the private placement[3] of unregistered securities issued by a FINRA member or by a control entity of a FINRA member. "Control entity" means any entity that controls or is under common control with a member, or that is

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1 Regulatory Notice 09-27, http://www.finra.org/Industry/Regulatory Notices/2009/P118738. On March 19, 2008, the Securities and Exchange Commission ("SEC") approved Rule 5122, SEC Release No. 34-59599, http://www.sec.gov/rules/sro/finra/2009/34-59599.pdf.

2 The filing requirement is intended to allow FINRA staff to identify those offering documents that are deficient "on their face" from the other requirements of the rule and differs from that in Rule 5110 (Corporate Financing Rule) in that there is no requirement for a member to wait for the FINRA staff to issue a "no-objections" letter before commencing the offering.

3 Rule 5122(a)(4) defines a private placement as "a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act [of 1933]."

controlled by a member or its associated persons.[4] "Control" is defined for purposes of Rule 5122 as having a beneficial interest 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 noncorporate legal entity.[5]

By itself, the power to direct the management or policies of a corporation or partnership (e.g., the power of the general partner of a partnership) does not constitute "control" for purposes of Rule 5122. Performance and management fees earned by a general partner should not be included when determining partnership profit or loss percentages for purposes of the Rule, unless such performance and management fees are subsequently reinvested in the partnership, increasing the general partner's ownership interest. Entities may calculate the percentage of control using a "flow through" concept by multiplying the ownership percentages at each ownership level to calculate the total percentage of control. The determination of control should be made immediately after the closing of an offering, and if the member firm elects to conduct the private placements in stages, Rule 5122(a)(3) requires that determination of control be made after each such offering closes.

The Notice clarifies that the Rule applies to a member firm selling its own securities or those of a control entity, and therefore it would not apply when the member firm with the conflict is not selling the securities, but they are sold by another member firm that is not a control entity of the first firm.

Exemptions from Rule 5122

FINRA has also exempted many types of offerings from the Rule. Rule 5122 does not apply to MPOs sold solely to institutional accounts,[6] qualified purchasers, qualified institutional buyers, investment companies, banks, and entities composed exclusively of qualified institutional buyers.

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4 FINRA By-laws Article I (rr) provides that a "person associated with a member" or an "associated person of a member" means: (1) a natural person who is registered or has applied for registration under the Rules of the Corporation; (2) a sole proprietor, partner, officer, director, or branch manager of a member, or other natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with the Corporation under these By-Laws or the Rules of the Corporation.

5 Rule 5122 looks to the definition of "beneficial interest" in the New Issue Rule, 5130(i)(1), which is any economic interest, such as the right to share in gains or losses, but it does not include the receipt of a management or performance-based fee for operating a collective investment account, or other fees for acting in a fiduciary capacity.

6 As defined in NASD Rule 3110(c)(4).

In addition, certain offerings are exempted from Rule 5122, including offerings of Rule 144A and Regulation S securities, securities of a commodity pool operated by a commodity pool operator and offerings to employees and affiliates of the issuer or its control entities, among others.[7]

FINRA has clarified in the Notice that the exemptions may be combined to provide an exemption for an offering, and mentions as an example an offering made to both qualified purchasers and to employees and affiliates of the issuer and its control entities.

Practical Implications

Even though many private placement offerings would be exempt from Rule 5122 and its filing and use of proceeds requirements, many offerings may not be, including offerings exempt from the Investment Company Act of 1940 under Section 3(c)(1) but not 3(c)(7). Therefore, FINRA members not wanting to be subject to Rule 5122 should take care that, at the time of any closing of a private placement offering not qualifying for an exemption, no more than 50 percent of the beneficial interest in the issuer is held by the FINRA member or its associated persons.

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If you have any questions regarding this memorandum, please contact, Martin R. Miller (212-728-8690, mmiller@willkie.com) or Marc J. Lederer (212-728-8624, mlederer@willkie.com), or the attorney with whom you regularly work.

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May 28, 2009

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[7] Other exempt offerings include those 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 percent of the securities in the offering), offerings of exempted securities with short term maturities, certain subordinated loans, "variable contracts," certain modified guaranteed annuity contracts and modified guaranteed life insurance policies, certain equity and credit derivatives, including over-the-counter ("OTC") options, provided that the derivative is not based principally on the member or any of its control entities, offerings filed with FINRA under Rules 5110, 2720 and 2810, offerings of unregistered investment-grade rated debt and preferred securities and offerings of securities issued in conversions, stock splits and restructuring transactions executed by an already existing investor without the need for additional consideration or investments on the part of the investor.