FINRA Proposes to Regulate Member Private Offerings

For the first time, FINRA is proposing filing, disclosure and use-of-proceeds requirements in private placement offerings by broker-dealers and their control entities. These requirements go well beyond current SEC requirements and will regulate the offering of certain private investment funds by affiliated broker-dealers. If adopted, this FINRA proposal would provide an additional means for FINRA to scrutinize the offering and operations of private investment funds affiliated with broker-dealers. Regulatory activity in this area will certainly increase in the wake of the Madoff scandal.

A "control entity" for this purpose is one which controls or is under common control with a broker-dealer, or is controlled by the broker-dealer or its associated persons.

"Control" would mean the 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 non-corporate entity. Control would be determined after giving effect to the proposed offering, but if the offering were less successful than anticipated, the requirements of the rule could be retroactively applicable, although it is not clear how literal compliance with the proposed rule is possible on a retroactive basis. Performance and management fees earned by a general partner would not be included in the determination of partnership profit or loss percentages, but reinvestment of those amounts would be included.

The rule provides that a broker-dealer and associated persons could not offer or sell securities in a member or a control entity unless the offering met the following requirements:

1. **Filing**. The private placement memorandum (PPM) or term sheet, if any, for the offering must be filed with the FINRA Corporate Financing Department (Department) at or prior to the time it is provided to any prospective investor. The filing requirement is intended to allow the Department to identify those offering documents that are deficient "on their face," but no approval or disapproval procedure is contemplated or required by the proposed rule. A broker-dealer would be permitted to commence a private placement immediately after making the required filing. If there is no PPM or term sheet, an offering document meeting the disclosure requirements of the proposal must be prepared and filed at that time. Amendments and exhibits to the PPM, term sheet or an offering document must also be filed within 10 days of being provided to any investor.
2. **Disclosure**. The PPM, term sheet or other offering document must be provided to each prospective investor and must disclose the intended use of offering proceeds, the expenses of the offering, and the selling compensation to the broker-dealer and its associated persons.
3. **Use of Proceeds**. At least 85 percent of the offering proceeds must be used for "business purposes" disclosed in the PPM, which does not include expenses of the offering. Offering expenses could exceed 15 percent of proceeds, but the excess could not be paid from proceeds. In a series of member private offerings, the 85 percent limit shall apply to each offering in a series.

The proposal would exempt offerings sold solely to:

- institutional accounts, as defined in NASD Rule 3110(c)(4);
- qualified purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940; and
- qualified institutional buyers as defined in Rule 144A under the Securities Act of 1933 (Securities Act), investment companies and banks.

Offerings solely to "accredited investors," as defined in Rule 501 of Regulation D under the Securities Act, in which investors do not otherwise meet one of the exemptions described above, would be subject to the proposed rule, notwithstanding that Regulation D does not impose any particular information requirements with respect to offerings solely to accredited investors under Rule 506.

In addition, the following types of offerings would be exempt from the proposed rule:

- offerings of exempt securities, as defined in Section 3(a)(12) of the Securities Exchange Act of 1934 (Exchange Act);
- offerings made pursuant to Rule 144A or Regulation S under the Securities Act;
- offerings in which a member acts primarily in a wholesaling capacity;
- offerings of subordinated loans under Rule 15c3-1 under the Exchange Act;
- offerings of variable contracts; offerings of modified guaranteed annuity contracts and modified guaranteed life insurance policies;
- offerings of unregistered investment grade rated debt and preferred securities;
- offerings to employees and affiliates of the issuer or its control entities;
- offerings of securities issued in conversions, stock splits and restructuring transactions to existing investors without additional consideration;
- offerings of securities of a commodity pool operated by a commodity pool operator;
- offerings of equity and credit derivatives, provided the derivative is not based principally on the member or any of its control entities; and
- offerings filed with the Department under Rule 5110 or NASD Rules 2720 or 2810.

The full text of the proposed rule change is available at FINRA's Web site.

If you have any questions about the proposed amendments, please do not hesitate to contact your regular Ropes & Gray contact.