FINRA and the Private Placement Market

By Morris N. Simkin

Introduction

Recent studies by the SEC staff show that the private placement marketplace is larger than the publicly offered markets and even larger when offerings under Rule 144A, Regulation S and Securities Act Section 4(a)(2) are included. At the same time broker-dealers have only participated in some 13% of the offerings made in the private placement market. Nonetheless, FINRA (Financial Industry Regulatory Authority) has adopted Rule 5123 and Form 5122/5123 to regulate this market. FINRA has also issued pronouncements about brokers acting as private placement agents that appear to be contradictory to FINRA's Suitability Rule (FINRA Rule 2111) and would impose additional duties on brokers acting as private placement agents. This article will discuss these pronouncements in more detail.

Size of the Private Placement Market

In 2012 and 2013 the SEC's Division of Economic and Risk analysis issued two white papers on raising capital in the U.S. under[1] Regulation D (The Regulation D Analyses).

The Regulation D analyses were based upon a review of Form Ds that had been filed electronically with the SEC since 2009 pursuant to Securities Act Rule 503. The authors noted that these reports likely understated the size of the private placement market for several reasons. These included:

a) Form Ds were usually filed within 15 days after the first sale or when a previous filing was being updated. So there was a reasonable probability that they did not report the full amount sold;
b) Not all the offerings under Regulation D were reported on Form D, as filing was not a requirement for the safe harbor registration exemption offered by Regulation D; and
c) Sales under Rule 144A, Regulation S and Section 4(a)(2) were not included.

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Nonetheless, the reported size of the market under Regulation D was enormous:

Table 1

Year	Capital Raised (in billions)
2009	$595
2010	$1,025
2011	$863
2012	$903

All in all, over 234,000 investors purchased securities offered in reliance on Regulation D during this four (4) year period.

The Regulation D analyses showed that in each of the four (4) years studied, offerings under Regulation D far exceed offerings under any other method:

Table 2

	Regulation D Offerings	Public Equity	Public Debt	Rule 144A	Regulation S	Section 4(a)(2)
2009	20,841	941	1,445	1,240	294	648
2010	29,445	1,072	1,930	1,607	262	668
2011	30,710	863	1,465	1,302	97	862
2012	31,471	954	1,473	1,302	13	518

Broker-Dealer Participation

The Regulation D Analyses found that broker-dealers and finders participated in just 13% of the Regulation D offerings made in this four (4) year period. The average fee paid to these participants was 6.5 % for offerings of up to $1 million and less than 2% for offerings over $50 million.

What FINRA Did

FINRA Rule 5123 applies to member firms that sell securities in a non-public offering, and requires member firms to file Form 5122/5123 electronically within 15 days of the first sale in a non-public offering, subject to certain exemptions.

Rule 5123(a) requires a member firm that sells a security in a non-public offering exempt from registration under the Securities Act of 1933 to submit or have submitted on its behalf to FINRA a copy of the private placement memorandum, term sheet or other offering document and any materially amended version thereof used in connection with the offering or indicate to FINRA that no such offering documents were used. The filing is to be made within 15 calendar days of the first sale by that member firm. The rule became effective December 3, 2012.

Rule 5123(b) exempts certain offerings from the filing requirement. The exemption is on a firm by firm basis. So one firm participating in a non-public offering may not have to file a report, but another firm participating in the same offering may have to file. There are 14 exempt types of offering. But the most relevant are those where the sales are to institutional or substantial investors. These include sales to the following:

- Institutional investors (accounts whose holders have over $50 million in assets);
- Qualified purchasers as defined in the Investment Company Act;
- Qualified institutional buyers as defined in Securities Act Rule 144A (Investor with over $100 million in securities);
- Eligible contract participants as defined in the Commodity Exchange Act (among others, entities with a net worth over $1 million who enter into contracts to manage the risks of their assets; broker-dealers, futures commission merchants; pension plans with over $5 million in assets and are managed by a third party; SEC registered investment advisers; commodity trading advisers; and individuals with over $10 million in discretionary investments);
- Accredited investors, as defined in SEC Rule 501, that are institutions and not individuals; and
- SEC registered investment companies.

The 5122/5123 Notification Filing, in its present format, was adopted effective July 1, 2013. It is to be filed in the FINRA Member Firm Gateway via the Web CRD system operated by FINRA.[2] It requires identifying the firm filing the form and the issuer of the securities being sold. It also asks if a Form D was filed with the SEC. In addition it asks the following six (6) questions that a filing firm must answer yes, no or unknown:

- Is this a contingency offering;
- Does the issuer have any independently audited financial statements for the most recent fiscal year;

- May the issuer use the proceeds to make or repay loans to, or purchase assets from any officer, director or executive management of the issuer, sponsor, or an unaffiliated general partner;
- Does the issuer have a board of directors comprised of a majority of independent directors or an unaffiliated general partner;
- Has the issuer engaged or do you anticipate that it will engage in a general solicitation in connection with the offering or sale of the securities; and
- Has the issuer, any officer, director or executive management of the issuer, sponsor, general partner, manager, advisor or any of the issuer's affiliates been the subject of SEC, FINRA or state disciplinary actions or proceedings or criminal complaints in the last 10 years.

Sullivan & Cromwell commented on these questions in a July 3, 2013 letter to the SEC. It noted that FINRA had said that these six (6) questions did not impose undue burdens on member firms because the firm could answer unknown. However, Sullivan & Cromwell expressed the view that these six (6) questions will effectively define the scope of a member's due diligence obligations in respect of the points covered.

What FINRA Said: Due Diligence: Suitability

The Sullivan & Cromwell letter refers to the question of what due diligence investigation a member firm conducting a private placement/non-public offering must conduct. In Regulatory Notice 10-22 (April 2010) FINRA stated that a broker-dealer has an obligation to conduct a reasonable investigation of the issuer and the securities it recommends in offerings under SEC Regulation D, private placements. This includes several parts. If the broker-dealer notes any red flags in the offering, it has a duty to follow up, as well as to investigate any substantial adverse information about the issuer. The Regulatory Notice stated that if a broker-dealer lacks essential information about an issuer or its securities when it makes a recommendation it must disclose the risks arising from this lack of information. If the broker-dealer relies on information supplied by the issuer it is a facts and circumstances determination whether it has conducted a reasonable investigation. The Regulatory Notice set forth a suggested list of areas of inquiry by the broker-dealer.

Regulatory Notice 10-22 is consistent with the (then) NASD suitability rule as well as the current FINRA suitability rule (FINRA Rule 2111). Whether a recommendation has been made is a facts and circumstances determination.[3] The determination requires an analysis of the content and context of the particular communication or set of communications. It is an analysis of whether the particular communication or set of communications to the customer reasonably would be viewed as a "call to action" or suggestion that the customer engage in a securities transaction.[4] In Regulatory Notice 12-25 (May 2012) FINRA issued additional guidance as to its new suitability rule. Among other things, this Regulatory Notice stated that distribution of offering materials ordinarily would not constitute a recommendation. It reaffirmed this in Frequently Asked Questions FINRA Rule 2111 (Suitability). In "Sale of Private Placements Frequently Asked Questions (FAQ)" FINRA stated under "Filing Form" Questions 2 and 3 that firms participating in a private placement are required to conduct a reasonable investigation of the issuer and the issue, and no new obligation has been imposed upon the member beyond that set forth in Regulatory Notice 10-22.

Recent studies by the SEC staff show that the private placement marketplace is larger than the publicly offered markets and even larger when offerings under Rule 144A, Regulation S and Securities Act Section 4(a)(2) are included.

But recent statements by FINRA have called this interpretation into question and state that a due diligence obligation applies in the case of private placements even where the broker-dealer does not make a recommendation. They state that a broker-dealer participating in a non-public offering has a duty to conduct a due diligence investigation into the issuer and the security being offered. The last three (3) Regulatory and Examination Priority Letters that FINRA sent to the executive representatives and chief compliance officers of its member firms took this position. The January 31, 2012 letter said:

> Firms conducting private placements under Regulation D or any other applicable exemption from registration must conduct a reasonable investigation of the issuer, based upon the facts and circumstances, with careful attention to any "red flags," to comply with the anti-fraud provisions and other FINRA rules, such as suitability.

In the January 11, 2013 letter FINRA said:

> FINRA also reminds member firms that the relative scarcity of independent financial information and the uncertainty surrounding the market and credit risk exposures associated with many private placements necessitates reasonable due diligence on prospective issuers…. Our primary concern is that inadequate due diligence regarding private placements could expose customers to harm and result in insufficient disclosure.

The January 2, 2014 letter stated that reviews of the filed Form 5122/5123 indicate that broker-dealers may not be performing their reasonable inquiry responsibilities.

The answer to "Filing Form" question 4 of the "Sale of Private Placements Frequently Asked Questions (FAQ)" stated that if the information as to whether proceeds could be used to make or repay loans to/from or purchase assets from the issuer's officers, directors, etc. was not in the offering memorandum but that the member firm had learned that the issuer would not so use the proceeds, the member firm should answer that question "no." This suggests that if the member firm learns of material information that is not in the offering documents it has no obligation to disclose that information to prospective investors. This is contrary to the anti-fraud rules that if a broker has material inside information it must disclose that to a person to whom it is seeking to sell a security to or buy a security from.

Concerns

The increasing size of the private placement market, the limited role of broker-dealers in placing these securities and the obligations under FINRA Rule 5123 and the filing of Form 5122/5123 burdens have been placed upon the broker-dealers that may make it increasingly costly for them to participate in making private placements. If this obligation is expanded to require that they conduct a reasonable due diligence about the issuer and the securities and disclose that they have done so and what they have found may well make their participation in private placements too costly for most issuers to use broker-dealers as intermediaries.

ENDNOTES

1 "Capital Raising in the U. S.: the Significance of Unregistered Offerings under the Regulation D Exemption, V. Ivanov and S. Baguess; February 2012; SEC Division of Economic and Risk Analysis; and Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009-20012, V. Ivanov and S. Baguess; SEC Division of Economic and Risk analysis, July 2013

2 Regulatory Notice 13-26 (August 2013)

3 NASD Notice to Members 01-23 (April 2001)

4 *Ibid*