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Via email to pubcom@finra.org

Mr. Gary L. Goldsholle
Vice President and Associate General Counsel
Office of General Counsel
Financial Industry Regulatory Authority, Inc.
1735 K Street NW
Washington, DC 20006-1506

In Re: Comments Concerning Proposed Amendments to FINRA Rule 5122

Dear Mr. Goldsholle:

This letter is submitted in response to the request for comments to FINRA's proposed amendments to existing Rule 5122 (as described in Notice to Members 11-04). Each of the undersigned attorneys is a member of the Securities Committee of the Business Law Section (the "Section") of the State Bar of Texas. Mr. Waller is also the Chairman of the Securities Committee of the American Association of Attorney-Certified Public Accountants. Each of the undersigned advises securities broker-dealers concerning private placements and their participation in same, and represents numerous sponsors of private placements (some of which are sold by an affiliated securities broker-dealer.) The comments expressed in this letter represent the views of the undersigned only and do not represent the official position of the State Bar of Texas, the Section, its Securities Committee or the American Association of Attorney-Certified Public Accountants.

The Proposed Amendments Are Not Necessary or Practical.

NTM 11-04 indicates that FINRA believes that the existing Rule 5122, which became effective only on June 17, 2009, does not provide adequate protection to investors from fraud and abuse in the private marketplace. The existing rule was designed by FINRA to respond to perceived abuses by "broker-dealers and **their control entities.**" (Emphasis added.) The proposed amendments to Rule 5122 would effectively extend FINRA's jurisdiction far beyond policing the activities of its own members and associated persons. If adopted, the proposed amendments would substantively give FINRA the authority to regulate private capital formation by persons and entities to which its jurisdiction does not extend, namely issuers of securities

being placed privately by securities broker-dealers, and do so in a merit-based fashion that is at odds with the general disclosure-based regulatory scheme for such offerings.

General Participation Would Fall Under Rule 5122 If The Proposed Amendments Are Adopted.

The proposed amendments accomplish such an expansion by incorporating into Rule 5122 the rather broad definition of "participation" found in FINRA Rule 5110 (a)(5), which defines "participation" as:

> Participation in the 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, but not the preparation of an appraisal in a savings and loan conversion or a bank offering or the preparation of a fairness opinion pursuant to SEC Rule 13e-3.

Rule 5110 is a corporate financing rule generally applicable to public offerings of registered securities. By using such a broad definition of "participation," even a FINRA member's furnishing to an issuer of other services commonly used in private placements would, if the proposed amendments are adopted, likely result in the FINRA member (and thus that issuer) falling under Rule 5122 and its merit-based approach to private offering regulation. Again, such an approach is contrary to the general regulatory scheme for such offerings, which is disclosure-based.

The Proposed Amendments Run Counter to the Regulatory Scheme for Private Offerings.

Sponsors of all private placements, whether sold through control affiliates or otherwise, must comply with applicable exemptions from securities registration provided under state and federal law. By and large, the most commonly-relied upon exemption is Rule 506 of SEC Regulation D. Rule 502 of SEC Regulation D prescribes the nature of disclosure applicable to Rule 506 offerings, incorporating many of the disclosure obligations set forth in SEC Regulation S-K. As drafted, the proposed amendments to Rule 5122 would appear to prohibit a FINRA member from selling an otherwise properly disclosed offering under Rule 506 and would significantly alter the regulatory framework under which private placements are conducted. Rule 506 does not place limits on the amount of compensation that may be paid to a securities broker-dealer or the amount of offering costs and other expenses incurred during an offering. However, those costs would obviously have to be disclosed to prospective purchasers in the private placement who could then exercise their own judgment as to whether to participate in the placement. The proposed amendments to Rule 5122, in essence, substitute the judgment of FINRA regarding whether an investor in a private placement should or should not invest in an offering in which offering costs and compensation exceeding 15% is paid.

The Proposed Amendments' Filing Provisions Pose Practical Problems for FINRA & Members.

We are also concerned about the proposed amendments' requirement that FINRA members file offering documents and any changes to such documents with the Corporate

Financing Department for review and potential comment. It matters little that no member would be required to await FINRA approval of such documents before completing an offering. Many private placements are conducted over a very short period of time—some across the course of just a few days or weeks. Yet, it seems reasonable to expect, given the significant volume of private placement activity in the United States and the degree to which members participate in such offerings, that confirmation that FINRA staff has no comments could stretch well beyond such brief time-frames.[1] And, broker-dealers are extremely likely to hesitate to sell an issuer's securities before such confirmation since FINRA staff may object to a disclosure after the offering is completed—a point in time when revisions to such disclosure are impractical.

The Proposed Amendments Create Ambiguity for Both Issuers and Selling Broker-Dealers.

A Problematic Lack of Clarity Regarding "Offering Expenses" and "Compensation".

The language in the proposed amendments does not provide clear guidance as to what constitutes "offering expenses" or "compensation" that can be paid to selling agents by affiliated or non-affiliated sponsors. The proposed amendments, at a minimum, should be clarified in this regard.

For example, in the case of an affiliated issuer and broker-dealer, the affiliated issuer or the broker-dealer may receive "back-in" compensation in the form of an enhanced participation in distributions of cash made by a partnership, a "carried working interest" in an offering of oil and gas interests or partnerships or limited liability company interests or other forms of "back-in" compensation that constitute a negotiated form of non-cash compensation to either the member firm, its affiliated issuer or a non-affiliated issuer and member firm. We do not believe that the definition of "compensation" should include non-cash sales incentives which are not immediately paid out of the funds raised during the offering period inasmuch as this form of compensation depends upon the success of the venture and occurs only when the investor realizes the benefits of participation in a private placement.

Issues With The Proposed Amendments' Provisions Regarding Use of Offering Proceeds.

The proposed amendments' provisions concerning the use of offering proceeds will, if adopted, impose significant costs, legal issues and potential exposure to liability upon FINRA members that become subject to Rule 5122, which at a minimum will preclude such members from being involved in small offerings.

Certain language in the proposed amendments, as set forth in Rule 5122(b)(1)(A)(i) and (B), requires that a term sheet be provided to each prospective investor containing the "intended use of the proceeds." The proposed amendments to Rule 5122, as set forth in subpart (b)(3),

[1] In calendar year 2010 alone, 17,589 initial Form D and 11,874 Form D amendment filings were made with the SEC. (Source: Gerald J. Laporte, Chief of the Office of Small Business Policy, Division of Corporation Finance, U.S. Securities and Exchange Commission (e-mail to John Fahy, March 11, 1011)). According to NTM 11-04, "FINRA staff's review of a sample of filing made in 2010 indicates that approximately 15 percent disclosed broker-dealer participation in a particular offering."

would also require that a member know that at least 85% of the offering proceeds are being used for the "**business purposes** required to be disclosed by paragraph (b)(1)(A)(I)." (Emphasis added.) And, the language of subpart (b)(4) of the proposed amendments could be read to literally require members and associated persons to control the offering as such subpart states that, "If . . . after the fact one or more conditions of this Rule have not been met, the member or associated person **must promptly conform the offering to comply with this Rule**." (Emphasis added.) In short, these provisions, if the proposed amendments are adopted, will require even securities broker-dealers that are not affiliated with an issuer to both know and control whether such issuer's use of offering proceeds is consistent with the disclosures required to be made by the proposed amendments. The result, in all likelihood, will be added expense, trouble and litigation for FINRA members and associated persons regarding what were once straight-forward placement activities.

Generally speaking, in most private placements participating member firms receive, on a fully-disclosed basis, anywhere from 6.5% to 15% of the proceeds from an offering as compensation for their efforts. In most instances, these are negotiated fees, the amount of which depend upon, among other things, the expected length of the offering period, the character of the private placement and the efforts expected to be expended by the securities broker-dealer engaged to sell the product. This compensation is typically in the form of cash. The balance of the proceeds raised are then used by the issuer for the purposes disclosed within the offering memorandum, and may include (i) fees for ongoing management of the newly-formed venture or the existing business, (ii) reimbursement of actual costs incurred in the organization and structuring of the offering for private sale, (iii) investment in the infrastructure of the core business, whether it be real estate, oil and gas or research and development, and (iv) legal and accounting fees incurred to bring the product to private market. From our perspective, it is not reasonable to expect that a FINRA member firm should act as an "auditor" of any issuer, particularly non-affiliated issuers, to confirm that at least 85% of the offering proceeds have been used for the described business purposes. After private capital is raised, the issuer bears responsibility for adhering to the representations it makes to its investors, namely, that the offering proceeds will be used as are described within the offering memorandum. Again, the proposed amendments to Rule 5122 appear to require that FINRA member firms now also shoulder that responsibility, which will add considerable expense and complexity alone to sales agreement negotiations. [2]

It is not feasible for securities broker-dealers, particularly ones that are not affiliates of issuers, to conduct ongoing examinations of the activities to be funded by issuers' private placements to determine and force compliance with the proposed amendments' 85% rule. At the very least, such a requirement would add another layer of expense and complexity to private placements in which FINRA members participate as the necessary undertakings were negotiated and documented with issuers who may not even be affiliates. Practically speaking, such undertakings will likely involve issuers providing audited financial statements during the pendency of such activities, which will preclude many issuers from using FINRA members in the first instance as placement agents. As for those FINRA members that are engaged as

[2] The proposed amendment does not state whether the reimbursement or payment by issuers of legal and accounting fees are to be included in the calculation of the 15% compensation calculation.

placement agents after any adoption of the proposed amendments, they face the possibility that, if an issuer (even an unaffiliated one) either fails to provide them with access to information showing compliance with the 85% or refuses to conform the offering to such rule, then both the Enforcement Department and investors may commence proceedings to hold such member responsible for what is solely the issuer's breach of the undertaking.

In addition, compliance with the 85% rule may not be possible for issuers seeking to raise and deploy capital in stages if all capital called from an investor pursuant to any such offering is not included in the calculation of that rule since it is from the initial payments by investors that such a private placement's offering expenses are typically and necessarily paid. Even if the 85% rule is intended to be calculated in this manner, which is not clear from the proposed amendments, if capital commitments alone are not considered offering proceeds for purposes of the 85% rule calculation, then many issuers will be faced with the conundrum of violating that rule if they return un-deployed capital initially paid by investors or fail to call and deploy additional capital.

Consider, for example, an energy exploration and development company that is seeking to privately place through a FINRA member fractional units of participation in the operating (working) interest of an oil and gas well (i.e., a security), which is a very common type of offering for such issuers. If that issuer requires investors to pay at the closing of its offering their respective percentage amounts of all of the capital needed to drill, test and complete the well, but later determines after drilling and testing the well that completing it will not result in the well producing in commercial quantities, such issuer's return to investors of un-deployed capital (i.e., the portion of offering proceeds that were to be used for completion of the well) could result in its private placement agent's violation of the 85% rule depending upon the relative proportion of such und-deployed capital to the total amount of capital committed to the project by investors (unless the FINRA member used an undertaking to block any such return of capital and force the completion of the commercially unproductive well). Similarly, if that same issuer merely required investors to commit at the closing of such offering to pay their respective percentage amount of completion costs, rather than paying them up-front with the amounts needed to drill and test the well, but never called on that commitment because the well could not be completed to produce in commercial quantities, the 85% rule may also have been violated depending upon the relative proportion of such un-called capital to the total amount of the offerings capital commitments (and whether the FINRA member uses any undertaking to force the calling of such commitments and the completion of the commercially unproductive well).

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We believe that FINRA should give careful consideration as to whether existing Rule 5122 needs to be amended. We view the changes proposed by NTM 11-04 to Rule 5122 as not merely an "amendment" of that rule, but rather, a new rule which goes far beyond the scope of the current Rule 5122 and would not, in all likelihood, eliminate what FINRA believes to be fraud and abuse within the private placement industry. At the very least, FINRA should re-think certain of the provisions set forth in the proposed amendments for all of the reasons set forth above and re-publish for further comment.

Thank you for giving us the opportunity to address our concerns regarding the breadth and scope of the proposed amendments to Rule 5122.

Sincerely,

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