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FINRA Proposes New Rule 5122 to Regulate Private Offerings by Members or their Control Entities

On January 16, 2009, the Securities and Exchange Commission ("SEC") published for a second round of comments a new rule (Rule 5122) proposed for adoption by the Financial Industry Regulatory Authority, Inc. ("FINRA") to regulate "member private offerings" - the private placement of unregistered securities issued by a FINRA member ("Member"), or by a "control entity" of a Member. The proposed rule would increase the disclosure and filing requirements of Members and control entities for an offering subject to Rule 5122 and impose limitations on the use of offering proceeds.

Sponsors should be aware of this potential new rule. Sponsors of private offerings with affiliated broker/dealers who are Members may be subject to the additional disclosure requirements and limitations on the use of proceeds if it is determined that the sponsor is a "control entity" with respect to the offering.

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Control Entities

The proposed rule would apply to both issuing Members and "control entities." A control entity is any entity that controls or is under common control with a Member, or that is controlled by a Member or its associated persons. "Control" is defined as a beneficial interest in more than 50% of the outstanding voting securities in a corporation, or the right to more than 50% of the distributable profits or losses of a partnership or other non-corporate legal entity. The existence of control is determined immediately after each closing of the offering.

Rule Summary

Under the proposed rule, the issuing Member or control entity of a non-exempt Member private offering would be subject to the following requirements:

- Disclosure in the private placement memorandum, term sheet or other offering document, to both accredited and non-accredited investors, of the intended use of offering proceeds and offering expenses.
- Filing of the disclosure document with FINRA on or before the date on which the document is first provided to any prospective investor.
- Committing to the use of at least 85% of the offering proceeds for business purposes, which would not include offering costs, discounts, commissions or any other form of sales incentives (a de facto 15% limitation on organizational and offering costs).

Additional Considerations

Under the proposed rule, the common legal entities used for funds, such as LLCs or LPs, would not be subject to the definition of control that references a beneficial interest in 50% of outstanding voting securities. Control for such entities would instead be governed by the definition referencing a 50% beneficial interest in distributable profits or losses. However, it remains unclear precisely what will be included in that calculation. The proposed rule states that performance and management fees earned by a general partner would not be included in calculating the general partner's interest in the partnership's distributable profit or loss. However, the proposed rule does not clarify whether income arising from a general partner's carried interest will be included in this determination as an interest in distributable profits, or whether such fees instead constitute performance fees that will not be factored into the calculation. Without further clarification, Members would need to proceed conservatively, and assume that the carried interest is included. In addition, it is unclear how the level of beneficial interest would be calculated if the carried interest is subject to a waterfall based on returns to investors.

Comment Submission

Sponsors should be aware of the implications of being deemed a "control entity" under the proposed rule. Sponsors with concerns about the rule are encouraged to discuss these implications with us and/or send comments to the SEC in one of the following ways:

Electronic Comments

- Use the SEC's Internet comment form: <http://www.sec.gov/rules/sro.shtml>. Reference File Number SR-FINRA-2008-020.
- E-mail rule-comments@sec.gov. Subject line: File Number SR-FINRA-2008-020.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. Reference File Number SR-FINRA-2008-020.

This Hirschler Fleischer Update has been prepared for the general information of our clients and other interested persons. This Update is not intended as legal advice or as an opinion on specific facts. For more information on these or any other securities issues, please contact Thomas G. Voekler at (804) 771-9599 or by e-mail at tvoekler@hf-law.com, Richard P. Cunningham, Jr. at (804) 771-9507 or by e-mail at rcunningham@hf-law.com, or Kathryn A. Lawrence at (804) 771-9579 or by e-mail at klawrence@hf-law.com.