



The Evolution of a Rule: FINRA Proposes Rule 5123 in lieu of Proposed Rule 5122

By: Seth Chertok

Introduction

FINRA stated that it is proposing to adopt new Rule 5123 (Private Placements of Securities) to ensure that investors in private placements are provided with detailed information about the intended use of offering proceeds, the offering expenses and offering compensation. In addition, new Rule 5123 would provide FINRA, through a member “notice” filing requirement, with more timely and detailed information about the private placement activities of member firms. As a result, FINRA believes that the rule will provide important investor protections in connection with private placements without unduly restricting capital formation. In addition, FINRA believes that the proposed rule change will assist its efforts to identify problematic terms and conditions in private placements, thereby helping to detect and prevent fraud.

Disclosure

Rule 5123(a) would prohibit a member or person associated with a member from offering or selling any security conducted in reliance on an available exemption from registration under the Securities Act (“private placement”), or from participating in the preparation of a PPM, term sheet or other disclosure document for a private placement, unless the member or associated person provides a PPM or term sheet to each investor prior to sale. The information provided to the investor must describe the anticipated use of offering proceeds, the amount and type of offering expenses, and the amount and type of compensation provided or to be provided to sponsors, finders, consultants and members, and their associated persons in connection with the offering. In private placements without a PPM or term sheet, the member or associated person must prepare a document that contains these disclosures and provide it to each investor prior to sale.

Notice Filings

Proposed Rule 5123(b) would require “notice” filings of members’ private placement activities. Specifically, the proposed Rule would require participating members or associated persons to file the PPM, term sheet or other disclosure document (including exhibits) with FINRA no later than 15 calendar days after the date of first sale, and to file any material amendments to such document, or any amendments to the disclosures mandated by the Rule, with FINRA no later than 15 calendar days after the date such document is provided to any investor or prospective investor.

Exemptions

Proposed Rule 5123(c) would exempt from the requirements of the Rule several types of private placements. Exemptions include offerings sold only to any one or more of the following purchasers:

- institutional accounts, as defined in NASD Rule 3110(c)(4);¹
- qualified purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act;
- qualified institutional buyers, as defined in Securities Act Rule 144A;
- investment companies, as defined in Section 3 of the Investment Company Act;
- an entity composed exclusively of qualified institutional buyers, as defined in Securities Act Rule 144A;
- banks, as defined in Section 3(a)(2) of the Securities Act; and
- employees and affiliates of the issuer.

In addition, the Rule would exempt the following types of offerings:

- offerings of exempted securities, as defined in Section 3(a)(12) of the Exchange Act;
- offerings made pursuant to Securities Act Rule 144A or SEC Regulation S;
- offerings of exempt securities with short term maturities under Section 3(a)(3) of the Securities Act;
- offerings of subordinated loans under SEA Rule 15c3-1, Appendix D (see NASD Notice to Members 02-32 (June 2002));
- offerings of “variable contracts” as defined in Rule 2320(b)(2);
- offerings of modified guaranteed annuity contracts and modified guaranteed life insurance policies, as referenced in Rule 5110(b)(8)(E);
- offerings of non-convertible debt or preferred securities by issuers that meet the eligibility criteria for incorporation by reference in Forms S-3 and F-3;²
- offerings of securities issued in conversions, stock splits and restructuring transactions that are executed by an already existing investor without the need for additional consideration or investments on the part of the investor;
- offerings of securities of a commodity pool operated by a commodity pool operator as defined under Section 1a(11) of the Commodity Exchange Act; and
- offerings filed with FINRA under Rules 2310, 5110, 5121 and 5122.

These proposed exemptions are very similar to the exemptions in existing Rule 5122 (Member Private Offerings), upon which proposed Rule 5123 is based. The only differences in the exemptions are that the current proposed Rule would not exempt (1) offerings in which a member acts in a wholesaling capacity and (2) offerings of certain credit derivatives, both of which are exempted from Rule 5122.

¹ The SEC approved SR-FINRA-2010-052, which, when it becomes effective on December 5, 2011, will transfer the definition of “institutional accounts” currently found in NASD Rule 3110(c)(4) to FINRA Rule 4512(c).

² FINRA noted that the SEC recently adopted amendments to remove any references to credit ratings from its rules and forms promulgated under the Securities Act of 1933 and the Securities Exchange Act of 1934. See, e.g., Security Ratings, Securities Act Release No. 9245 (July 27, 2011), 76 FR 46603 (August 3, 2011). FINRA is proposing to use the references described therein in the proposed rule change.

The basis for the wholesaling exemption in Rule 5122 was that distribution of the private placement by independent retail broker-dealers would obviate the need for the rule, which applies to private placements in which the selling member or its control entity is the issuer. However, given that the current proposed rule change applies to all private placements, the reliance upon the efforts of an “independent” broker-dealer is no longer relevant. Accordingly, the wholesaling exemption is not provided in proposed Rule 5123.

The exemption for offerings of equity and credit derivatives was intended to avoid attributing certain derivative products on unaffiliated issuers as a “member private offering.” However, since proposed Rule 5123 would apply to all offerings in which a member participates, that distinction is not relevant to Rule 5123.

FINRA noted that the exemption provisions may be combined, since these exemptions are derived from those in Rule 5122. For example, if an MPO is offered to both qualified purchasers and employees or affiliates of the issuer or its control entities, as long as these purchasers qualify for exemptions under the rule, the MPO would be exempt from the rule’s requirements.

Furthermore, proposed paragraph 5123(e) would provide members with a method for application of an exemption from the provisions of the Rule for good cause pursuant to the Rule 9600 Series.

Confidentiality

Proposed Rule 5123 contains provisions identical to those in current Rule 5122 regarding confidential treatment and application for exemption. Pursuant to proposed paragraph 5123(d), FINRA would accord confidential treatment to all documents and information filed pursuant to the Rule, and would use such documents and information solely for the purpose of determining compliance with FINRA rules or other applicable regulatory purposes. FINRA stated that Rule 5123 would afford confidential treatment to all comment or similar letters by FINRA, and thus they could not be discovered by a litigant through any legal action.

Relationship to Regulatory Notice 11-04

In January 2011, FINRA published Regulatory Notice 11-04 requesting comment on proposed amendments to expand Rule 5122 (the “11-04 Proposal”). The 11-04 Proposal would have extended virtually all of the existing requirements of Rule 5122, i.e., those requiring disclosure, filing and limitations on the use of offering proceeds, to all private placements in which a member participates (subject to the listed exemptions). As a result of the differences between the 11-04 Proposal (and Rule 5122) and the current proposed Rule, FINRA proposed that the rule regarding private placements be a new rule separate from Rule 5122.

Use of Offering Proceeds Limitation

The issue generating the most comments was the proposed use of offering proceeds limitation (i.e., the proposed requirement that 85 percent of the offering proceeds raised be used for the business purposes described in the disclosure document). Based in large part on the comments, FINRA amended the proposal such that it no longer included the substantive requirement that at least 85 percent of offering proceeds must be used for the disclosed business purposes and instead reoriented the provisions of the Rule towards disclosure.

While FINRA continues to believe that the manner in which offering proceeds are used is critically important in a private placement – and that offerings in which a large percentage of offering proceeds are used for other than business purposes raise regulatory concerns – FINRA believes that these concerns can be addressed through the obligations of broker-dealers, under the suitability and anti-fraud provisions of securities laws and FINRA rules, to conduct a reasonable inquiry of an issuer.³ FINRA’s expectation is that the reasonable inquiry obligations of

³ See Regulatory Notice 10-22 (April 2010) (Regulation D Offerings).

broker-dealers will encourage reasonable limits on the use of offering proceeds for purposes other than generating a return on investment. If the rigorous application of reasonable inquiry obligations outlined in Regulatory Notice 10-22 does not achieve this result, FINRA will reconsider the imposition of numerical limitations.

Filing Requirements

The 11-04 Proposal would have required a member to file information with FINRA by the time an offering document is provided to any investor. Commenters raised concerns, among others, about potential slowdowns of offerings due to the filing requirement. In response to these comments, FINRA now proposes to require that a member file “no later than 15 calendar days after the date of first sale.”

This timing requirement is the same as the filing requirement for Form D. Synchronizing these timing requirements may allow some filers to utilize operational efficiencies. Moreover, by requiring a “notice” filing, FINRA will remove any implication that the FINRA staff will provide comments on a filing; that such filing with FINRA could be a precondition to commencing an offering; or that members should expect to receive any FINRA staff input before proceeding with an offering. The proposed filing requirement would nevertheless provide FINRA staff with timely access to information about the private placement business of FINRA members.

Furthermore, FINRA stated that it is more practical, and more helpful to FINRA’s need for timely access to information about the private placement business of members, to require every member that participates in a particular private placement to fulfill the notice filing requirement.

Implementation Date

FINRA will announce the implementation date of the proposed rule change no later than 90 days following SEC approval. The implementation date will be no more than 180 days following SEC approval.

Contacts

Seth Chertok
(415) 268-6531
schertok@mof.com

Nilene Evans
(212) 468-8088
nevans@mof.com

Anna Pinedo
(212) 468-8179
apinedo@mof.com

Gerd Thomsen
(212) 336-4335
gthomsen@mof.com

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We’ve been included on *The American Lawyer’s* A-List for eight straight years, and *Fortune* named us one of the “100 Best Companies to Work For.” Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mof.com. © 2011 Morrison & Foerster LLP. All rights reserved.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.