

Corporate Finance Alert

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SEC Approves Revised FINRA Rule Requiring Filing of Private Placements

On June 7, 2012, the U.S. Securities and Exchange Commission (SEC) approved a rule change filed by the Financial Industry Regulatory Authority, Inc. (FINRA) to adopt new FINRA Rule 5123 (Private Placements of Securities), which establishes filing requirements for FINRA members with respect to certain private placements of securities.¹

When implemented by FINRA, Rule 5123 will require that a FINRA member, or another member acting on its behalf, either submit the private placement offering document to FINRA or notify FINRA of the private placement and state that an offering document was not used, unless an exemption from the rule is available.

Rule 5123 will be implemented on a date to be announced by FINRA in a Regulatory Notice, which must be published no later than 90 days (September 5, 2012) following the date of SEC approval of the new rule. The implementation date that will be announced will be no later than 180 days (December 4, 2012) following the date of SEC approval of the new rule.

The new rule does not apply to private placements of securities that are issued by FINRA members or a "control entity" of a member, which are subject to a separate filing requirement and scheme of disclosure regulation under FINRA Rule 5122 (Private Placements of Securities Issued by Members).

Background

In January 2011, FINRA issued Regulatory Notice 11-04 proposing to amend Rule 5122 (Private Placements of Securities Issued by Members) so that the disclosure and filing requirements of the rule also would apply to almost all private placements by issuers not affiliated with a FINRA member.

In response to various concerns of commenters, FINRA withdrew its proposal to amend Rule 5122. Instead, in October 2011, FINRA submitted a proposal to the SEC to adopt new Rule 5123, which would apply to private placements other than those covered by FINRA Rule 5122. This proposal would have required that FINRA members that participate in an offering exempt from registration under the Securities Act of 1933 (Securities Act) file with FINRA a private placement memorandum, term sheet or other offering document (the offering document) prepared by the issuer or by the member that includes disclosures regarding the issuer's intended use of offering proceeds, the amount and type of offering expenses, and the amount and type of compensation to be provided to sponsors, finders, consultants and FINRA members. The rule also would have applied to private placements in which a FINRA member "participates," which would have encompassed a FINRA member's consulting and advisory activities to an issuer. The SEC published the proposal for comment in October 2011.²

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On January 19, 2012, FINRA filed Partial Amendment No. 1 to proposed Rule 5123 with the SEC (the Partial Amendment) to address concerns raised by market participants. The Partial Amendment narrowed the rule to those private placements that are “non-public” offerings, *i.e.*, private placements, and to those FINRA members that sell securities in the offering. The Partial Amendment also eliminated the provisions that would have required that FINRA members prepare a disclosure document in the event that the issuer did not use an offering document and, instead, required that a FINRA member in such case notify FINRA of its sales of the private placement. FINRA also added several new categories of exemptions in response to the requests of commenters and otherwise clarified and simplified numbers of provisions.

After the SEC republished the Partial Amendment for further comment in January 2012,³ FINRA filed Partial Amendment No. 2 to proposed Rule 5123 on March 12, 2012, which eliminated the proposed disclosure requirements of the rule. Instead, the new rule would require that FINRA members that sell a private placement security either file a copy of the offering document or, in the event an offering document is not used, a notification of the private placement with FINRA within 15 calendar days after the date of first sale.

On March 22, 2012, FINRA filed Partial Amendment No. 3 to proposed Rule 5123 in order to clarify that “any materially amended versions” of the offering document must also be filed with FINRA within 15 calendar days after the date of the first sale using the amended offering document.

Summary of New Rule 5123

Notice Filing Requirements: New Rule 5123(a) establishes requirements for FINRA members to file information with FINRA with respect to private placements of securities, unless an exemption from the rule is available. FINRA explained that the filing requirements of Rule 5123 are intended to be a “notice” filing, in order to remove any implication that FINRA staff will provide comments on a filing or that such filing with FINRA could be a precondition to commencing an offering, or that FINRA members should expect to receive any FINRA staff input before commencing an offering.⁴

FINRA defined the term “private placement” to only encompass “non-public offerings of securities conducted in reliance on an available exemption from registration under the Securities Act.” Therefore, the revised rule avoids the overly broad scope of the original proposal, which would have applied to offerings exempt from SEC registration requirements but nonetheless public in nature. Therefore, the new rule does not apply to securities offered pursuant to the following provisions:

- Securities Act Sections 4(1), 4(3) and 4(4) (secondary transaction exemptions);
- Securities Act Sections 3(a)(2) (offerings by banks), 3(a)(9) (exchange transactions with an existing holder, where no one is paid to solicit the exchange), 3(a)(10) (securities subject to a fairness hearing), or 3(a)(12) (securities issued by a bank or bank holding company pursuant to reorganizations or similar transactions); or
- Section 1145 of the Bankruptcy Code (securities issued in a court-approved reorganization plan that are not otherwise entitled to the exemption from registration afforded by Securities Act Section 3(a)(10)).

Rule 5123(a), when implemented, will require that each FINRA member that sells a security in a private placement that uses an offering document in connection with sales submit to FINRA, or have submitted on its behalf by a designated member, a copy of the offering document within 15 calendar days of the date of the first sale by that FINRA member. In addition, a FINRA member will be required to submit, or have submitted on its behalf by a designated member, any materially amended version of the offering document within 15 calendar days of the date of first sale using the amended offering document.

The filing obligation is individual to each FINRA member. Therefore, the 15-day period is measured from the date of the first sale or from the date of the first sale through the use of an amended version of an offering document by the individual FINRA member, regardless of whether any other FINRA member has previously made sales or used an amended version of an offering document. The 15-day period for the filing requirement is the same as the time period required for filing SEC Form D.

The new rule only will apply to those FINRA members that engage in sale transactions with respect to a private placement. Therefore, FINRA Rule 5123 will “not apply to members that merely provide advisory, consulting or administrative services for an issuer, or in connection with a private placement, but are not otherwise making any offer or executing any sale of securities in respect of such private placement.”⁵

In the case of a private placement where an offering document is not provided to investors, the new rule will require that each FINRA member that sells a security in such private placement “indicate to FINRA that no such offering documents were used.” The Approval Order explains that each FINRA member that sells such a private placement, or each member acting on behalf of each such member, will be required to make a notice filing with FINRA no later than 15 calendar days after the date of the first sale by that FINRA member identifying the private placement and the participating members and stating that no offering document is being used.⁶

Exemptions: Rule 5123(b) sets forth exemptions from the notice filing requirements of the rule for private placements that are sold to certain types of investors, for offerings made in reliance on certain exemptions from SEC registration, and for offerings of certain types of securities, which include several new exemptions that are not found in FINRA Rule 5122.

Exemptions for Sales to Certain Types of Investors

In the case of the exemptions for offerings sold to certain types of investors, a FINRA member will be exempt from the filing requirement of the rule if the individual FINRA member solely makes sales of the private placement to one or more of the ten listed types of investor. Therefore, a FINRA member can avoid inadvertent violations as a result of sales by another firm because it can rely on a filing exemption based only upon sales by that firm. Further, the text of the rule is clear that exemptions for sales to types of purchasers can be combined.

A FINRA member is exempt from the rule’s filing requirements if the member makes sales of a private placement’s securities solely to one or more of the following types of investors.

- Qualified institutional buyers, as defined in Securities Act Rule 144A.
- Institutional accredited investors, as described in Securities Act Rule 501(a)(1), (2), (3) or (7). This category only exempts those accredited investors that are institutions such as banks, insurance companies, broker-dealers, private business development companies, trusts with total assets in excess of \$5,000,000 (which trust is not formed for the specific purpose of acquiring the securities offered), and 501(c)(3) entities not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000. *Individual accredited investors are not exempted under this provision.*⁷
- Affiliates of the issuer, as defined in Rule 5121,⁸ and employees. This category includes any affiliate or employee even if he or she is not an accredited investor.
- Institutional accounts, as defined in FINRA Rule 4512(c). This category covers a bank, savings and loan association, insurance company, registered investment company, an investment adviser registered with the SEC or a state securities commission or any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million.

- Qualified purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940 (Investment Company Act). This category includes any natural person who owns not less than \$5,000,000 in investments, as defined by the SEC.
- Investment companies, as defined in Section 3 of the Investment Company Act. This category covers an issuer that is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of such issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis.
- 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.
- Knowledgeable employees, as defined in Investment Company Act Rule 3c-5. This category includes executive officers, directors, trustees, general partners, advisory board members, or persons serving in a similar capacity and employees who, in connection with their regular functions or duties, participate in investment activities for at least 12 months.
- Eligible contract participants, as defined in Section 3(a)(65) of the Securities Exchange Act of 1934 (Exchange Act).

Exemptions for Sales of Certain Exempt Offerings and Securities

Rule 5123 contains exemptions for:

- Offerings pursuant to Securities Act Rule 144A or SEC Regulation S;
- Offerings of exempted securities, as defined in Section 3(a)(12) of the Exchange Act (such as government securities, municipal securities and certain securities excluded from the definition of "investment company" such as common trust funds, single trust funds and certain church plans);
- Offerings of exempt securities with short-term maturities (not to exceed nine months) under Section 3(a)(3) of the Securities Act (such as notes, drafts, bills of exchange or banker's acceptances);
- Offerings of subordinated loans under Exchange Act Rule 15c3-1, Appendix D;
- Offerings of "variable contracts," as defined in FINRA Rule 2320(b)(2);
- Offerings of modified guaranteed annuity contracts and modified guaranteed life insurance policies, as referenced in FINRA Rule 5110(b)(8)(E);
- 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 a commodity pool operated by a commodity pool operator, as defined under Section 1(a)(11) of the Commodity Exchange Act; and
- Public offerings filed with FINRA under FINRA Corporate Finance Rules 2310, 5110, 5121 and 5122 or exempt from filing thereunder in accordance with Rule 5110(b)(7).⁹

FINRA also added filing exemptions for offerings of:

- Debt securities sold by members pursuant to Section 4(2) of the Securities Act so long as the maturity does not exceed 397 days and the securities are issued in minimum denominations of \$150,000 (or the equivalent thereof in another currency).
- Nonconvertible debt or preferred securities that meet the transaction eligibility criteria for registering primary offerings of nonconvertible securities on Forms S-3 and F-3. This exemption does not require that the securities be registered on Form S-3 or F-3, but rather that the securities would meet the eligibility standards to be filed on Form S-3 or F-3 if the offering were registered.¹⁰
- Business combination transactions as defined in Securities Act Rule 165(f).
- Registered investment companies.
- Standardized options, as defined in Securities Act Rule 238.

In addition to the foregoing exemptions, a FINRA member also may apply for an exemption from the rule for good cause shown pursuant to Rule 5123(d).

Confidentiality: Rule 5123(c) provides that FINRA shall accord confidential treatment to all documents and information filed pursuant to the rule. The provision also states that FINRA shall use the documents and information solely for the purpose of review to determine compliance with the provisions of applicable FINRA rules or for other regulatory purposes deemed appropriate by FINRA. FINRA stated that this provision would prevent a litigant from obtaining copies of any comment or similar letters prepared by FINRA with respect to a private placement.¹¹

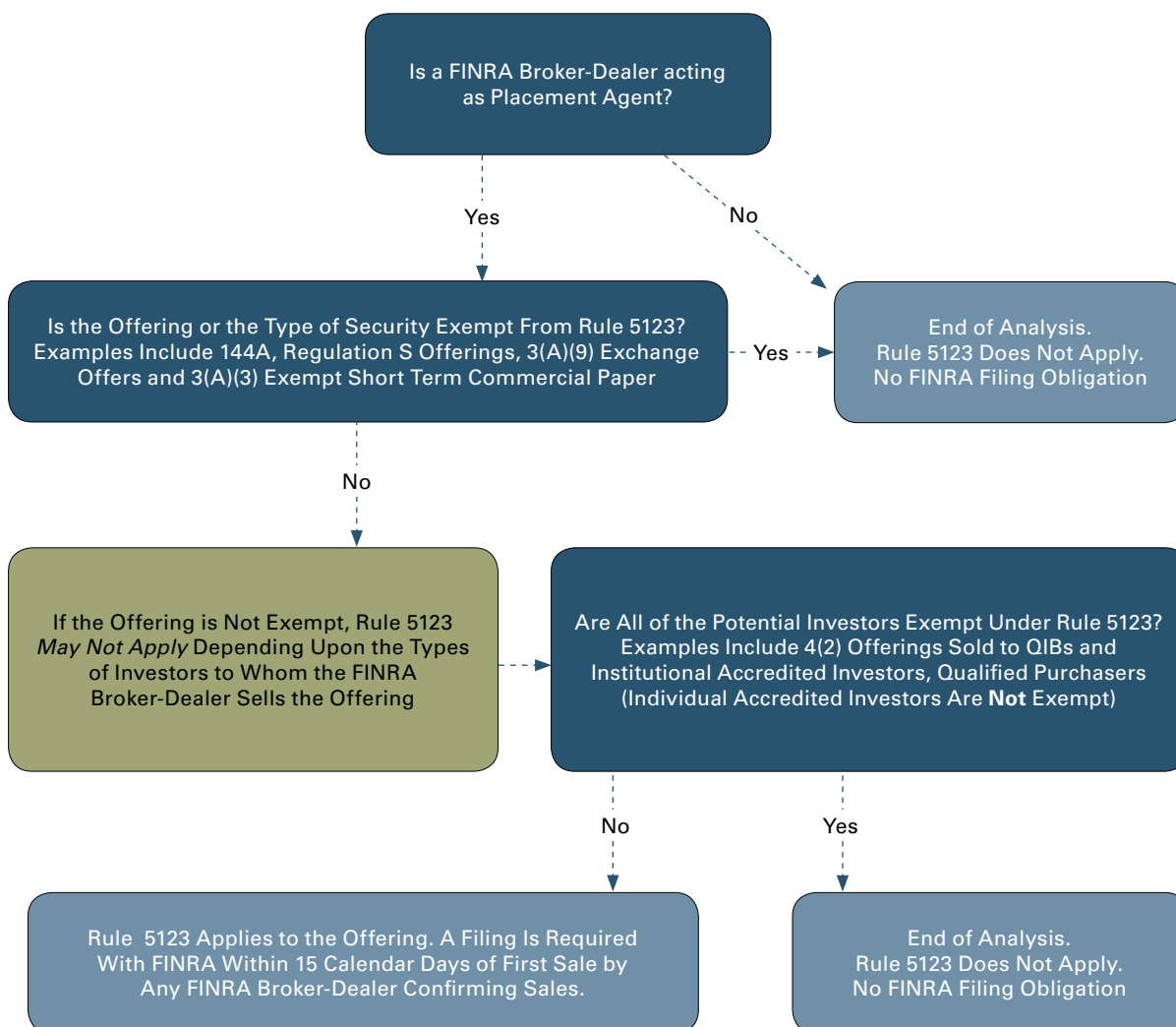
FINRA Review Process

In its filings with the SEC and in public forums, FINRA discussed the system to be used for the submission of private placement filings and its intended process for the review of information filed under new FINRA Rule 5123. Information on private placements will be submitted via a new filing system available to FINRA members on the FINRA website. FINRA intends to review notice filings using sophisticated document review technology and trained staff to identify red flags. FINRA stated that it will use the information it receives pursuant to the new rule to further its detection and prevention of fraudulent and manipulative acts and practices. FINRA explained that, in some cases, FINRA staff will contact the FINRA member to obtain information on the “scope and results of their investigations pursuant to their suitability rule obligations.”¹²

FINRA emphasized in its filing with the SEC that NASD Rule 2310,¹³ which governs members’ suitability obligations, requires members to conduct a “robust and thorough suitability analysis before recommending securities in a private placement. This analysis requires a reasonable investigation into the offering and an understanding of its features, including the fees and expenses and the use of proceeds.” FINRA referenced FINRA Regulatory Notice 10-22 (April 2010), which describes specific issues relating to the scope of FINRA members’ responsibilities to conduct a reasonable investigation in a private placement under NASD Rule 2310, supervisor responsibilities under NASD Rule 3010 and recordkeeping requirements, as well as the obligations of FINRA members that participate in the preparation of the offering document and any sales literature under NASD Rule 2210 (Communications With the Public).¹⁴

Compliance Matrix

When a FINRA member sells unregistered securities, the FINRA member will be required to determine whether (1) the offering is considered a private placement subject to FINRA Rule 5123 and (2) whether an exemption from the filing requirements of Rule 5123 is available. Even if the offering is a private placement subject to Rule 5123, if the offering is exempt either because the FINRA member is making sales solely to certain categories of investors or because the offering is of certain securities or relying on certain SEC registration exemptions, proposed Rule 5123 will not apply and no FINRA filing would be required. If no exemption is available, proposed Rule 5123 would apply. If Rule 5123 would apply to a private placement, the FINRA member will be required to either file the offering document with FINRA or provide FINRA with information on the private placement within 15 calendar days of the date of the first sale by that FINRA member.



END NOTES

- 1 [SEC Release No. 34-67157](#) (June 7, 2012); [77 F.R. 35457](#) (June 13, 2012) (Approval Order).
- 2 [SEC Release No. 34-65585](#) (Oct. 18, 2011); [76 F.R. 65758](#) (Oct. 24, 2011).
- 3 [SEC Release No. 34-66203](#) (Jan. 20, 2012); [77 F.R. 4065](#) (Jan. 26, 2012).
- 4 See, [SEC Release No. 34-65585](#) (Oct. 18, 2011); [76 F.R. 65758](#) (Oct. 24, 2011), at 65761.
- 5 See, [FINRA letter to the SEC dated January 19, 2012](#) (January Letter), at 5.
- 6 See, [SEC Release No. 34-66203](#) (Jan. 20, 2012); [77 F.R. 4065](#) (Jan. 26, 2012), at 4067.
- 7 FINRA rejected suggestions for exemptions to be provided to sophisticated individual investors such as qualified clients, as defined in the Investment Advisers Rule 205-3(d)(1), and accredited investors who are individuals, as defined in Rule 501(a) of the Securities Act. FINRA stated in the January Letter that it believes that “the qualified client and accredited investor standards do not by themselves require a sufficiently high level of sophistication to warrant exception.” [January Letter](#), at 22.
- 8 Specifically, as defined in [FINRA Rule 5121\(f\)](#), the term “affiliate” means “an entity that controls, is controlled by or is under common control with a member.”
- 9 [FINRA Rule 5110\(b\)\(7\)](#) exempts certain public offerings from filing with FINRA for review even though such offerings remain subject to the compensation, disclosure and other requirements of [Rule 5110](#).
- 10 FINRA proposed this exemption to conform with the SEC’s recent removal of references to credit ratings in certain rules and forms. Forms [S-3](#) and [F-3](#) specify certain securities offerings that may be registered on such forms.
- 11 See, [SEC Release No. 34-65585](#) (Oct. 18, 2011); [76 F.R. 65758](#), at 65762.
- 12 [January Letter](#), at 13.
- 13 NASD Rule 2310 has been replaced by FINRA Rule 2111, effective July 9, 2012. See [FINRA Regulatory Notices 11-02](#) (January 2011), [11-25](#) (May 2011) and [12-25](#) (May 2012).
- 14 [January Letter](#), at 7-8.

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