

SEC Approves New FINRA Rule 5123: Private Placement of Securities

The U.S. Securities and Exchange Commission ("SEC") recently approved a revised version of proposed FINRA Rule 5123 governing private placements of securities.¹ The new rule requires Financial Industry Regulatory Authority ("FINRA") members to file certain information with the regulator regarding covered offerings, but exempts most types of offerings from its coverage.² The practical effect of the new rule will be to marginally increase the burdens on FINRA members when selling private placements, such as private funds, to certain classes of accredited investors. FINRA has not yet established an effective date for the new rule.

Background

As originally proposed, the rule was highly controversial and not only generated significant industry pushback, but caused the SEC to issue a rare "Order Instituting Proceedings To Determine Whether To Approve or Disapprove a Proposed Rule Change" after initially

publishing the proposed rule for comment in the Federal Register. FINRA avoided possible disapproval of the proposed rule by eliminating the most controversial elements and adding exemptions to limit the scope of the rule.

The original rule proposal published for comment by FINRA in January 2011 would have expanded a different FINRA rule, Rule 5122, governing member private placements.³ Currently, Rule 5122 applies only to private placements in which a member or control person of a member has more than a 50 percent beneficial interest in the issuer. The original rule proposal would have lowered the beneficial interest threshold to 10 percent, meaning the rule would cover private placements in which the member or control person of the member had a beneficial interest of 10 percent or more. But the most controversial portions of the original rule proposal would have required FINRA members participating in a covered offering to describe the anticipated use of offering proceeds, offering expenses, and compensation in private placement memoranda ("PPMs"), term sheets, or other disclosure documents provided to investors,

¹ Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendments No. 2 and No. 3 and Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendments No. 1, No. 2, and No. 3 to Adopt FINRA Rule 5123 (Private Placement of Securities) in the *Consolidated FINRA Rulebook*, SR-FINRA-2011-057, Exchange Act Release No. 34-67157 (June 7, 2012) (hereinafter "Adopting Release"); 77 Fed. Reg. 35457 (June 13, 2012).

² "Covered offering," means a non-public offering made in reliance on an available exemption from registration under the Securities Act of 1933 ("Securities Act"). See FINRA Rule 5123(a).

³ See [Regulatory Notice 11-04: Private Placement of Securities](#) (Jan. 2011). Rule 5122 imposes, subject to limited exemptions, disclosure requirements regarding the use of offering proceeds, expenses and the amount of selling compensation to be paid in any private placement in which a member or its "control entity" is the issuer. Rule 5122 also requires that at least 85% of offering proceeds be used for the purposes identified in the offering document, as well as submission of such documents to FINRA for ex post reviews by FINRA staff.

even if the nature of the offering would not otherwise require the preparation of such disclosure documents.

Many offerings of private funds or alternative investment products, as well as private equity deals, would have been caught in the proposed amendments to Rule 5122 because private asset managers or private equity firms often take an ownership stake in a fund or portfolio company. The exemptions in the proposed amendments to Rule 5122 would have carved out sales to institutions, qualified purchasers (“QPs”), qualified institutional buyers (“QIBs”), investment companies, banks, and employees or affiliates of the issuer, among others, but would not have covered the sale of a fund exempt from registration under Section 3(c)(1) of the Investment Company Act of 1940 (“Investment Company Act”), for example.

Following pushback from the industry, including comment on the proposed lowering of Rule 5122’s definition of “control” from 50 percent to 10 percent beneficial ownership of the issuer, FINRA abandoned its efforts to amend Rule 5122 and instead proposed new Rule 5123 with a broader list of exemptions.⁴ However, Rule 5123, as proposed, retained the disclosure and exemption infirmities of the original proposal.

On October 24, 2011, the SEC published proposed Rule 5123 for comment in the Federal Register, generating 16 comment letters. FINRA then filed Amendment No. 1 to the proposed rule in response, leaving many of the more controversial provisions in place, and the SEC moved to disapprove the proposed rule.⁵ The SEC’s order requested comment on whether proposed Rule 5123 would: (i) discourage members from participating in private placements; (ii) promote the use of non-member firms to effect private placement transactions; and (iii) affect access to capital for issuers.⁶ In response, the SEC received 11 comments

⁴ FINRA received 35 comments on the original proposal to amend Rule 5122. Several commenters addressed the proposed change in the definition of “control.”

⁵ See generally, [Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Partial Amendment No. 1 and Order Instituting Proceedings To Determine Whether To Approve or Disapprove a Proposed Rule Change, as Modified by Partial Amendment No. 1, To Adopt FINRA Rule 5123](#) (Private Placements of Securities), SR-FINRA-2011-057, Exchange Act Release No. 34-66023 (Jan. 20, 2012) 77 Fed. Reg. 4065 (Jan. 26, 2012).

⁶ See *id.* 77 Fed. Reg. at 4067 (citing Section 19(b)(2) of the Securities Exchange Act of 1934 (“Exchange Act”), which requires the SEC to provide notice of the grounds for disapproval under consideration after instituting

on Amendment No. 1 and its order, prompting FINRA to file two additional amendments to the proposed rule. The SEC has now approved the rule subject to comments on FINRA’s two most recent amendments.⁷

Narrowing the Scope of the Rule and Eliminating the Disclosure Requirements

Rule 5123, as approved, requires FINRA members that engage in private placements (without regard to whether they control the issuer) to provide FINRA with copies of any PPMs, term sheets, or other disclosure documents used in connection with the sale of securities within 15 calendar days after the date of first sale.⁸ Where no such documents are created or used in connection with a covered offering, the new rule eliminates the obligation to create such a notice document. Instead, participating FINRA members will only be required to provide FINRA with notice that no disclosure documents were used in connection with the covered offering.⁹ The new rule also eliminates the mandate for the creation or delivery of disclosure documents to investors, and does not impose substantive disclosure requirements when such documents are used.¹⁰

proceedings to determine whether the proposed rule change should be approved or disapproved).

⁷ Amendment No. 2 eliminates the requirement that member firms participating in private placements provide certain disclosures to investors. See Adopting Release, 77 Fed. Reg. at 35461. Amendment No. 3 makes a technical change to the proposed rule, requiring member firms to provide any materially amended versions of offering documents used in connection with a private placement transaction to FINRA within a prescribed time period. See *id.*

⁸ This is a “notice filing” requirement only. Therefore, FINRA staff will not issue comments on any such filings, nor must a member make a filing before engaging in the private placement transaction. See Adopting Release, 77 Fed. Reg. at 35460-61. When disclosure documents are filed with FINRA, members have a continuing duty to provide FINRA with any material amendments to the disclosure documents within 15 calendar days of the date of first sale. See FINRA Rule 5123(a).

⁹ In an amendment to the original proposal, FINRA affirmed that the rule does not preclude the sale of private placement securities in a covered offering when no disclosure documents are created or used by the parties. See Adopting Release, 77 Fed. Reg. at 35458.

¹⁰ See Adopting Release 77 Fed. Reg. at 35461.

Additional Exemptions

Similar to the exemptions provided in Rule 5122, Rule 5123 exempts a variety of private placement transactions from its obligations and adds a number of additional exemptions.¹¹ Included among these exempted transactions are offerings to institutional accounts, QPs, QIBs, investment companies, banks, and employees or affiliates of the issuer, among others. Also exempted are offerings made in accordance with Rule 144A or Regulation S, as well as offerings of certain exempt securities, variable contracts, subordinated loans, non-convertible debt, preferred securities, and commodity pool offerings. The additional exemptions incorporated in Rule 5123, as approved, include: offerings sold to knowledgeable employees as defined in Investment Company Act Rule 3c-5; offerings sold to eligible contract participants, as defined in Section 3(a)(65) of the Exchange Act; offerings sold to the types of accredited investors described in Securities Act Rule 501(a)(1), (2), (3), and (7);¹² most short-term debt securities sold pursuant to Section 4(2) of the Securities Act; business combination transactions as defined

¹¹ In addition, FINRA clarified that members qualify for exemptions based on the sales that they themselves make. Therefore, the reporting requirement is not triggered by a non-exempt transaction made by another member within the same private placement. See Adopting Release, 77 Fed. Reg. at 35459.

¹² Included among these accredited investors are certain banks, savings and loan associations, brokers, dealers, insurance companies, business development companies, small business investment companies, as well as certain tax-exempt organizations and other entities not formed for the specific purpose of acquiring the private placement securities offered, with total assets in excess of \$5,000,000, and any trust, with total assets in excess of \$5,000,000, not formed for the specific purpose of acquiring the private placement securities offered, whose purchase is directed by a “sophisticated person,” among others.

in Securities Act Rule 165(f); and standardized options, as defined in Securities Act Rule 238.

These additional exemptions will remove most private placement offerings from the scope of the new rule. However, FINRA specifically declined to provide an exemption for covered offerings made to accredited investors in reliance on Rule 501(a)(4), (5) or (6) of Regulation D.¹³ FINRA stated that the criteria used to determine an individual’s status as an accredited investor under Rule 501(a)(4)-(6) does not “necessarily reflect a sufficiently high level of sophistication to justify exemption from the [new rule].”¹⁴

Request for Comments

The SEC has solicited comments on the two most recent FINRA amendments to the proposed rule while approving Rule 5123 on an accelerated basis. The comment period will close on July 5, 2012.



This update was authored by Elliott Curzon (+1 202 261 3341; elliott@dechert.com), Adam Teufel (+1 202 261 3464; adam.teufel@dechert.com) and Ross Oklewicz (+1 202 261 3423; ross.oklewicz@dechert.com), with research assistance by Matthew Barsamian.

¹³ Securities Act Rules 501(a)(4)-(6) exempt offerings to “[a]ny director, executive officer, or general partner of the issuer of the securities being sold, or any director, executive officer, or general partner of that issuer,” “[a]ny natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000,” and “[a]ny natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.”

¹⁴ Adopting Release, 77 Fed. Reg. at 35460.

Practice group contacts

For more information, please contact the authors, one of the attorneys listed or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financial_services.

Karen L. Anderberg
London
+44 20 7184 7313
karen.anderberg@dechert.com

David L. Ansell
Washington, D.C.
+1 202 261 3433
david.ansell@dechert.com

Margaret A. Bancroft
New York
+1 212 698 3590
margaret.bancroft@dechert.com

Sander M. Bieber
Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Thomas C. Bogle
Washington, D.C.
+1 202 261 3360
thomas.bogle@dechert.com

Julien Bourgeois
Washington, D.C.
+1 202 261 3451
julien.bourgeois@dechert.com

Kevin F. Cahill
Orange County
+1 949 442 6051
kevin.cahill@dechert.com

Christopher D. Christian
Boston
+1 617 728 7173
christopher.christian@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Douglas P. Dick
Washington, D.C.
+1 202 261 3305
douglas.dick@dechert.com

Karl J. Paulson Egbert
Hong Kong
+1 852 3518 4738
karl.egbert@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Allison Harlow Fumai
New York
+1 212 698 3526
allison.fumai@dechert.com

David M. Geffen
Boston
+1 617 728 7112
david.geffen@dechert.com

David J. Harris
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Christopher P. Harvey
Boston
+1 617 728 7167
christopher.harvey@dechert.com

Robert W. Helm
Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

Richard Horowitz
New York
+1 212 698 3525
richard.horowitz@dechert.com

Megan C. Johnson
Washington, D.C.
+1 202 261 3351
megan.johnson@dechert.com

Jane A. Kanter
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Geoffrey R.T. Kenyon
Boston
+1 617 728 7126
geoffrey.kenyon@dechert.com

Matthew Kerfoot
New York
+1 212 641 5694
matthew.kerfoot@dechert.com

Steven P. Kirberger
New York
+1 212 698 3698
steven.kirberger@dechert.com

Robert H. Ledig
Washington, D.C.
+1 202 261 3454
robert.ledig@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Gordon L. Miller
Washington, D.C.
+1 202 261 3467
gordon.miller@dechert.com

Jack W. Murphy
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Reza Pishva
Los Angeles
+1 213 808 5736
reza.pishva@dechert.com

Edward L. Pittman
Washington, D.C.
+1 202 261 3387
edward.pittman@dechert.com

Robert A. Robertson
Orange County
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson
Washington, D.C.
+1 202 261 3438
keith.robinson@dechert.com

Kevin P. Scanlan
New York
+1 212 649 8716
kevin.scanlan@dechert.com

Jeremy I. Senderowicz
New York
+1 212 641 5669
jeremy.senderowicz@dechert.com

Patrick W. D. Turley
Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

Brian S. Vargo
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

Thomas P. Vartanian
Washington, D.C.
+1 202 261 3439
thomas.vartanian@dechert.com

M. Holland West
New York
+1 212 698 3527
holland.west@dechert.com

Jennifer Wood
London
+44 20 7184 7403
jennifer.wood@dechert.com

Jeffrey S. Poretz
Washington, D.C.
+1 202 261 3358
jeffrey.poretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Michael L. Sherman
Washington, D.C.
+1 202 261 3449
michael.sherman@dechert.com

Stuart Strauss
New York
+1 212 698 3529
stuart.strauss@dechert.com

Anthony Zacharski
Hartford
+1 860 524 3937
anthony.zacharski@dechert.com

Robert Zack
New York
+1 212 698 3522
Robert.zack@dechert.com

Sign up to receive our other [DechertOnPoints](#).

Dechert
LLP

www.dechert.com

© 2012 Dechert LLP. All rights reserved. Materials have been abridged from laws, court decisions and administrative rulings and should not be considered as legal opinions on specific facts or as a substitute for legal counsel. This publication, provided by Dechert LLP as a general informational service, may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome.

Almaty • Austin • Beijing • Boston • Brussels • Charlotte • Chicago • Dubai • Dublin • Frankfurt • Hartford
Hong Kong • London • Los Angeles • Luxembourg • Moscow • Munich • New York • Orange County • Paris
Philadelphia • Princeton • San Francisco • Silicon Valley • Tbilisi • Washington, D.C.