FINRA Proposes New Rule for Certain Private Placements of Securities

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The Securities Exchange Commission ("SEC") published for comment in the Federal Register on October 24, 2011, Financial Industry Regulatory Authority, Inc. ("FINRA") Proposed Rule 5123 ("Proposed Rule"), [1] establishing certain disclosure and filing obligations for FINRA member firms and their associated persons that participate in a private offering of securities. The SEC solicited comments on: (i) the impact the Proposed Rule would have on issuers' access to capital through the private placement market; (ii) the extent to which the Proposed Rule would affect purchases of private placement securities from broker-dealers subject to the Proposed Rule; and, (iii) what consequences, if any, the Proposed Rule would have on broker-dealer participation in private offerings. Comments were due by November 14, 2011.

Disclosure Requirements

The Proposed Rule requires FINRA members participating in a private placement to provide private placement memoranda ("PPM"), term sheets, or other disclosure documents to investors before entering into a private sale of securities, even if the nature of the offering would not otherwise require the preparation of such disclosure documents. The disclosure must describe the anticipated use of offering proceeds, offering expenses, and compensation provided to third parties in connection with the offering.

Currently, member firms and their associated persons are only required to provide disclosures to investors when they engage in a private sale of their own securities, or those of a control entity. [2] If adopted, the Proposed Rule will increase the number of participants subject to the disclosure requirement by applying those obligations to any FINRA member or associated person who prepares a PPM, term sheet, or other disclosure document in connection with a private placement of securities, regardless of the participant's relationship to the issuer.

Filing Obligations

The Proposed Rule would also require each member participating in a private offering to file with FINRA certain disclosure documents related to the private placement within 15 calendar days of the initial sale of securities. [3]

This is a "notice filing" requirement only. Accordingly, FINRA will not issue comments on any filing or provide guidance to members participating in an offering based on information contained within the disclosure documents. [4]

In addition to the initial filing requirement, participating members would have a continuing duty to provide FINRA with any material amendments to the disclosure documents within 15 calendar days of the date that the member firms first provide amended disclosure to investors. FINRA will keep any information contained within these filings confidential. [5]

Exemptions

If implemented, the Proposed Rule will exempt from its obligations private offerings to institutional accounts, qualified purchasers ("QPs") as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940, qualified institutional buyers ("QIBs"), entities comprised exclusively of QIBs, investment companies, banks, and employees or affiliates of the issuer. Likewise, the Proposed Rule would exempt from its mandates 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 securities. The Proposed Rule does not expressly exempt 3(c)(7) funds from its scope; however, it exempts sales to QPs. Moreover, it does not expressly exempt sales by broker-dealers of non-U.S. securities to non-U.S. investors that do not fall under Regulation S, a circumstance which may arise with broker-dealers selling certain securities (e.g., UCITS) to foreign investors temporarily in the United States, in reliance on Section 4(2) of the Securities Act of 1933. Offerings made to non-institutional investors who do not qualify for QP or QIB status, which include investors in 3(c)(1) funds, would fall within the scope of the Proposed Rule.

Unlike Rule 5122, offerings in which a firm acts primarily in a wholesaling capacity would no longer be exempt from the Proposed Rule's disclosure and filing requirements. [6] Similarly, offerings of certain equity and credit derivatives would also trigger the Proposed Rule's reporting obligations. Although FINRA seeks to include these offerings within the ambit of its regulation, member firms and their associated persons may apply for an exemption from these requirements for "good cause." [7]

Comments

FINRA received 35 comments when it initially published the Proposed Rule for comment in Regulatory Notice 11-04 in January 2011. [8] In response to the comments it received, FINRA eliminated a requirement that issuers use at least 85 percent of the offering proceeds for disclosed business purposes. [9] In addition, FINRA explained that participants could combine multiple exemptions in a single offering without being obligated to satisfy the Proposed Rule's disclosure and filing requirements.

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Full Bio

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Dechert is a leading international law firm with 21 offices in the United States, Europe and Asia. Founded in 1875, the firm has grown to over 800 lawyers allowing us the resources to deliver seamless, high-quality legal services to clients wherever they do business.

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[1] *Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change to Adopt New FINRA Rule 5123 (Private Placements of Securities),* SR-FINRA-2011-057, Exchange Act Release No. 34-65585 (Oct. 18, 2011) *available* at http://sec.gov/rules/sro/finra/2011/34-65585.pdf [hereinafter *SEC Release*]; 76 FR 65758 (Oct. 24, 2011).

[2] *See* FINRA Rule 5122(a)(1) (restricting application of the disclosure and filing requirements to "member private offerings," defined as "a private placement of unregistered securities issued by a member or control entity").

[3] The Proposed Rule extends the period in which members or their associated person must file the appropriate disclosure documents with FINRA. Under Rule 5122(b)(2), members are required to file the disclosure documents with FINRA at, or before, the time the document is first provided to a prospective investor. The new 15-day period would harmonize the filing period with the current Form D filing requirement.

[4] FINRA maintains that the purpose of the filing requirement is to provide FINRA with timely and detailed information about the private placement business of its member firms and their associated persons. *SEC Release*, *supra* note 1, at 13.

[5] FINRA Proposed Rule 5123(d).

[6] The wholesaling exemption is present in Rule 5122 because that rule applied only to private placements involving securities issued by a member or control entity. When an independent retail broker-dealer acted as a wholesaler of third-party securities, the rule was no longer applicable. Under the Proposed Rule, however, all participants in a private placement, including independent broker-dealers, are subject to the disclosure and filing requirements. Therefore, the exemption no longer applies. *SEC Release, supra note* 1, at 15-16.

[7] FINRA is currently developing a process through which members could apply for this exemption pursuant to the FINRA Rule 9600 series. *Id*. at 15.

[8] *See* Proposed Amendments to FINRA Rule 5122, Regulatory Notice 11-04 (Jan. 2010).

[9] Rule 5122 requires that issuers use 85 percent of the private offering proceeds for "business purposes." Although FINRA contends that the use of proceeds from private placements continues to be a potential area of concern for investors, the organization believes that the suitability and anti-fraud provisions of the various federal, state, and private regulatory regimes will be sufficient to address these concerns. In particular, FINRA expects that the obligation of broker- dealers to conduct a "reasonable inquiry" into an issuer will protect investors from attempts to use offering proceeds for anything other than creating a return on investment. *See* Regulation D Offerings, FINRA Regulatory Notice 10-22 (Apr. 2010) (outlining the obligations of broker-dealers to conduct a "reasonable inquiry" into an issuer's use of offering proceeds before recommending its securities to investors).