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SEC Approves New FINRA Rule 5123: Private Placement of Securities

The US Securities and Exchange Commission (SEC) recently approved a revised version of proposed Financial Industry Regulatory Authority (FINRA) Rule 5123 governing private placements of securities.[1] The new rule requires 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. The new rule goes into effect on December 3, 2012.

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, 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 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]

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 of 1933 (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 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]

Notes

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 percent 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.

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 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, *supra* n.1, 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.* The Managed Funds Association (MFA), in a letter dated June 29, 2012 from Stuart Kaswell, Executive Vice President and General Counsel, commented that the Rule as approved by the SEC "conflicts with the longstanding regulatory framework for private fund offerings" by: (1) imposing filing requirements that are inconsistent with the nature of private placements; (2) adding "burdens and delays [that] would inhibit private funds from conducting offerings efficiently and obtaining needed capital to invest throughout the economy;" and (3) increasing uncertainty by broker-dealer placement agents about obtaining and filing documents. MFA also observed that the burdens imposed by the rule may discourage issuers and managers from using broker-dealers to conduct private offerings, "creat[ing] uncertainty for issuers and regulators."

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, *supra* n.1, 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, *supra* n.1, at 35458.

10. *See* Adopting Release, *supra* n.1, at 35461.

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, *supra* n.1, 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.

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, *supra* n.1, at 35460.