



SEC Adopts New FINRA Rule 5123 on Private Placements

On June 7, 2012, the Securities and Exchange Commission (the “SEC”) approved on an accelerated basis the Financial Industry Regulatory Authority, Inc.’s (“FINRA”) proposed FINRA Rule 5123 (Private Placement of Securities) (the “Approval Order”).¹ As approved, FINRA Rule 5123 (“FINRA Rule 5123”) requires members selling securities issued by non-members in a private placement to file the private placement memorandum, term sheet or other offering documents with FINRA within 15 days of the date of the first sale of securities, or indicate that there were no offering documents used.

As detailed below, FINRA Rule 5123 has undergone a significant transformation, including several rounds of comments and three amendments, in response to industry concerns that the proposed rule was too burdensome, resulting in the new notice filing requirement only.²

A Recap of the Background of FINRA Rule 5123

FINRA proposed new FINRA Rule 5123 (the “Proposed Rule”) on October 5, 2011.³ The Proposed Rule proved to be controversial. After receiving 16 comment letters, FINRA filed Partial Amendment No. 1 on January 19, 2012 to address the industry comments that the Proposed Rule was too burdensome.⁴ On January 20, 2012, the SEC instituted proceedings pursuant to Section 19(b)(2)(B) of the Securities and Exchange Act of 1934, as amended (the “Exchange Act”), to determine whether to approve or disapprove the Proposed Rule, as modified by the Partial Amendment No. 1, and sought additional comments (the “Notice and Proceedings Order”).⁵ The SEC received 11 comment letters in response to the Notice and Proceedings Order.⁶ To address the additional

¹ See 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 Placements of Securities) in the Consolidated FINRA Rulebook, Exchange Act Release No. 67517 (June 7, 2012), available at <http://www.sec.gov/rules/sro/finra/2012/34-67157.pdf>.

² We have discussed the evolution and contents of proposed FINRA Rule 5123 in prior client alerts available at <http://www.mofo.com/files/Uploads/Images/111010-FINRA-Proposes-Rule-5123-in-lieu-of-Proposed-Rule-5122.pdf> and <http://www.mofo.com/files/Uploads/Images/120126-FINRA-Rule-5123.pdf>.

³ FINRA originally proposed FINRA Rule 5123 in lieu of proposed Rule 5122. See the Proposed Rule available at <http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p124598.pdf> and our client alert available at <http://www.mofo.com/files/Uploads/Images/111010-FINRA-Proposes-Rule-5123-in-lieu-of-Proposed-Rule-5122.pdf>.

⁴ See Partial Amendment No. 1 available at <http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p125429.pdf> and FINRA response to comments available at <http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p125430.pdf>.

⁵ See 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), Exchange Act Release No. 66203 (Jan. 20, 2012), available at <http://www.sec.gov/rules/sro/finra/2012/34-66203.pdf> and our client alert available at <http://www.mofo.com/files/Uploads/Images/120126-FINRA-Rule-5123.pdf>.

⁶ See the Approval Order at note 8.

comments, FINRA filed Partial Amendment No. 2 and a response letter on March 12, 2012,⁷ and Partial Amendment No. 3 to the Proposed Rule on March 22, 2012.⁸ In Partial Amendment No. 2, as further clarified by Partial Amendment No. 3, FINRA proposed to eliminate the Proposed Rule's requirement for members to disclose specified information to investors.

In the Approval Order,⁹ the SEC stated that FINRA had addressed capital formation, competitive and efficiency concerns, including by: (i) eliminating the disclosure requirements, (ii) narrowly tailoring the rule to require only a notice filing, and (iii) creating additional exemptions under the rule.¹⁰ As required by the Notice and Proceedings Order, the SEC found FINRA Rule 5123, as modified, consistent with Section 15A(b)(6) of the Exchange Act,¹¹ noting that FINRA narrowly tailored the broker-dealer's obligations under FINRA Rule 5123, while enhancing its ability to carry out its statutory obligations to oversee member firms.¹²

The Scope

FINRA Rule 5123 is significantly narrower in scope than FINRA's original proposal. Notably, gone from the final rule are the obligations for members to:

- disclose to each investor the anticipated use of offering proceeds, the amount and type of offering expenses and offering compensation prior to sale of the securities, and
- create and provide to any potential investor a separate disclosure document containing the above information, if any issuer's disclosure document did not contain such information.

With the elimination of the requirement that member firms provide specified disclosures to investors, FINRA Rule 5123(a) contains only a notice filing requirement, intending to address the informational needs of FINRA with respect to oversight of its members' activities regarding private placements.

FINRA Rule 5123

Private Placements

FINRA Rule 5123 applies to a "private placement" which means, "a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act."¹³ The definition does not apply to securities offered pursuant to:

- Sections 4(1), 4(3), and 4(4) of the Securities Act (which generally exempt secondary transactions);
- Sections 3(a)(2) (offerings by banks), 3(a)(9) (exchange transactions), 3(a)(10) (securities subject to a fairness hearing), or 3(a)(12) (securities issued by a bank or bank holding company pursuant to reorganization or similar transactions), of the Securities Act; and

⁷ See rebuttal comment letter from FINRA, dated March 12, 2012, available at <http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p125798.pdf>. Partial Amendment No. 2 is available at <http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p126025.pdf>.

⁸ Partial Amendment No. 3 is available at <http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p126305.pdf>.

⁹ The Approval Order approves FINRA Rule 5123, as modified by Partial Amendments No. 1, 2 and 3. The SEC also asked for comments on Partial Amendment No. 2 and Partial Amendment No. 3. Comments are due on July 5, 2012.

¹⁰ See the SEC's findings in Section IV of the Approval Order.

¹¹ Section 15A(b)(6) requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

¹² The Proposed Rule, the amendments, the SEC notices, the comment letters and FINRA response letters and the Approval Order are available at <http://www.finra.org/Industry/Regulation/RuleFilings/2011/P124600>.

¹³ The term "private placement" has the same meaning as in FINRA Rule 5122.

- 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)).

Exemptions

FINRA Rule 5123 exempts other types of private placements from its notice filing requirement, including:

- offerings sold by a member solely to any one or more of the following purchasers:
 - institutional accounts, as defined in FINRA Rule 4512(c);
 - qualified purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act;
 - qualified institutional buyers, as defined in Rule 144A of the Securities Act;
 - investment companies, as defined in Section 3 of the Investment Company Act;
 - an entity composed exclusively of qualified institutional buyers, as defined in Rule 144A of the Securities Act;
 - banks, as defined in Section 3(a)(2) of the Securities Act;
 - employees and affiliates of the issuer;¹⁴
 - knowledgeable employees as defined in Investment Company Act Rule 3c-5;
 - eligible contract participants, as defined in Section 3(a)(65) of the Exchange Act; or
 - accredited investors as defined in Rule 501(a)(1), (2), (3) or (7) of the Securities Act.
- offerings of exempted securities, as defined in Section 3(a)(12) of the Exchange Act;
- offerings made pursuant to Rule 144A under the Securities Act or Regulation S;
- offerings of exempt securities with short-term maturities under Section 3(a)(3) of the Securities Act and 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);
- offerings of subordinated loans under SEA Rule 15c3-1, Appendix D;
- 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 FINRA Rule 5110(b)(8)(E);
- offerings of non-convertible debt or preferred securities by issuers that meet the transaction eligibility criteria for registering primary offerings of non-convertible securities on Forms S-3 or F-3;

¹⁴ Partial Amendment No. 1 clarified that the term “affiliate” for purposes of Rule 5123 would have the same meaning as in FINRA Rule 5121. Specifically, the term “affiliate” would mean, “an entity that controls, is controlled by or is under common control with a member.”

- 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 in Section 1a(11) of the Commodity Exchange Act;
- business combination transactions as defined in Securities Act Rule 165(f);
- offerings of registered investment companies;
- offerings of standardized options, as defined in Securities Act Rule 238; and
- offerings filed with FINRA under FINRA Rules 2310, 5110, 5121 and 5122, or exempt from filing thereunder in accordance with FINRA Rule 5110(b)(7).

A member qualifies for an exemption based upon the sales it makes rather than those of all members participating in the offering. Thus, the actions of one member would not affect the availability of an exemption for another member.¹⁵

Notice Filing Requirement

FINRA Rule 5123(a) provides that each member that sells a security in a private placement must:

- (i) submit to FINRA, or have submitted on its behalf by a designated member, a copy of any private placement memorandum, term sheet or other offering document, including any materially amended versions thereof used in connection with such sale, within 15 calendar days of the date of first sale; or
- (ii) indicate to FINRA that no such offering documents were used.

Accordingly, a member is still obligated to file with FINRA any disclosure document used in the private placement containing the requisite information about proceeds, expenses and compensation. If no such disclosure document exists, the member must prepare a notice filing identifying the private placement and the participating members, stating that no disclosure document was used, and file it with FINRA within the filing deadline.

As described in the Approval Order, FINRA clarified during the rulemaking process several aspects relating to the filing requirement, including:

- The notice filing requirement does not establish any review and approval process by FINRA for private placements.¹⁶
- Each member participating in an offering (or a member's designee) is required to file the disclosure document with FINRA.
- The filing requirement refers to the first sale by the member making the filing (or on whose behalf a designated member is filing), rather than the first sale by another member.

¹⁵ This was clarified by Partial Amendment No. 1.

¹⁶ See the Approval Order at note 33.

- The rule does not preclude sales of private placements in which no disclosure documents are used, and does not require the member to make any additional disclosure to investors in such offerings.

Confidentiality

FINRA Rule 5123 provides confidential treatment to all documents and information filed pursuant to the rule, and FINRA will use such documents and information solely for the purpose of determining compliance with FINRA rules or other applicable regulatory purposes.

Liability

During the rulemaking process, some commenters sought clarification about the liability of members for violations of FINRA Rule 5123. In response, FINRA stated that a wide range of regulatory responses is available for violations of FINRA Rule 5123, as is the case for violations of any FINRA rule.¹⁷ The regulatory response depends on the facts and circumstances of the violation, and any sanction imposed is subject to oversight and review by the SEC.¹⁸

Conclusion

FINRA Rule 5123 imposes a new notice filing requirement on members in private placements. While it may be good news that FINRA Rule 5123, as approved, is narrower in scope than originally proposed, member firms should start implementing procedures designed to identify private placements covered by FINRA Rule 5123 and to comply with the notice filing requirement.

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¹⁷ See FINRA's response letter, dated January 19, 2012, and in its rebuttal comment letter, dated March 12, 2012.

¹⁸ See the Approval Order at note 29, citing as an example FINRA Rule 9370 (Application to SEC for Review).