FINRA Proposes Rule 5123 to Require Filing of Private Placement Memoranda and Certain Disclosures

The Securities and Exchange Commission (SEC) recently issued a notice of a rule filing (the Rule Filing) to adopt the Financial Industry Regulatory Authority’s (FINRA) proposed Rule 5123 (the Proposed Rule). The SEC requests that comments be submitted by Monday, Nov. 14, 2011.

The Proposed Rule, among other things, would require FINRA members and associated persons to complete Notice filings of disclosure documents for private placements of securities and to provide disclosures to investors prior to sale concerning the anticipated use of offering proceeds. The Rule Filing would have a significant impact on the sale of hedge funds, private equity funds and venture capital funds through FINRA members (such as placement agents).

The subject matter of the Proposed Rule was originally set forth in different form in Regulatory Notice 11-04 (Jan. 2011) (Notice 11-04), which proposed an expansion of FINRA Rule 5122 (Member Private Offerings). In response to comments on Notice 11-04, FINRA drafted the Proposed Rule as a rule separate from Rule 5122. Importantly, in contrast to Notice 11-04, the Proposed Rule does not contain a substantive limitation on offering proceeds that may be used for purposes other than generating a return on investment.

Pre-Sale Disclosure Requirements

The Proposed Rule would require that FINRA members and associated persons that offer or sell private placements or participate in the preparation of disclosure documents, such as private placement memoranda (PPM) or term sheets, provide the following information to investors prior to sale: (1) the anticipated use of offering proceeds, (2) the amount and type of offering expenses and (3) the amount and type of compensation provided or to be provided to sponsors, finders, consultants and members and their associated persons. The Proposed Rule requires that, if the private placement is made with a PPM or term sheet, the required disclosures should be made in those documents. If the private placement is not made with a PPM or term sheet, the required disclosures must be made in another document provided to investors prior to sale.
We believe that FINRA’s *one-or-the-other* disclosure approach may prove difficult to implement. As a practical matter, some of the required disclosures may be addressed easily in a private placement’s PPM or term sheet, but other disclosures, such as, for example, disclosure of broker-specific compensation arrangements, would be more efficiently made in a broker-specific point-of-sale disclosure document. We will monitor the Rule Filing to determine whether this issue is addressed in the final version of the Proposed Rule.

**Post-Sale Notice Filings**

The Proposed Rule would require that the PPM, term sheet or any other disclosure document, and related exhibits, be filed with FINRA by *every* member that participates in a private placement within 15 calendar days after the date of each member’s first sale of the private placement. Additionally, material amendments to those documents or the disclosures required by the Proposed Rule would need to be filed with FINRA by every member that participates in a private placement within 15 calendar days after the amended document or disclosure is provided to investors or potential investors.

**FINRA’s Rejection of a Single-Filer System**

FINRA disclosed in the Rule Filing that it had considered a single-filer system, in which only one member in a private placement would be required to file; however, it opted not to incorporate such a system in the Proposed Rule, which requires that each member that participates in a private placement must make the notice filing. According to the Notice, FINRA’s decision to require that each FINRA member participating in a private placement make a notice filing was based on several factors, including: (1) a single-filer system might hinder FINRA’s timely access to information about the private placement business of FINRA members that might not file; (2) a single-filer system might complicate the ability of other members to participate in a private placement, since those members would have to determine whether the notice filing had already properly been made; and (3) a single-filer system would not provide FINRA information about cases in which one FINRA member engaged in a private placement under different compensation terms than another member in the private placement.

**Regulatory Notice 11-04 and the Use of Offering Proceeds Limitation**

FINRA originally planned to implement these requirements regarding private placement offerings by amending and expanding Rule 5122, which it proposed to do in Notice 11-04. As previously mentioned, due to comments received on Notice 11-04 and differences between Rule 5122 and the current Proposed Rule, FINRA determined that the Proposed Rule should be separate from Rule 5122.

Notice 11-04 proposed a use of offering proceeds limitation — that 85 percent of the offering proceeds raised be used for business purposes described in the disclosure document. Due in part to the number of comments in opposition to this proposal,
FINRA elected in the Proposed Rule not to include this substantive provision. Rather FINRA reiterated its belief, as outlined in Regulatory Notice 10-22 (April 2010)(Regulation D Offerings), that the obligation of member firms under the suitability and anti-fraud provisions of the securities laws and FINRA rules to conduct a reasonable inquiry of issuers will encourage reasonable limits on the use of offering proceeds for purposes other than generating a return on investment.

Exemptions From the Proposed Rule

FINRA proposes to provide exemptions for certain types of private placements from the Proposed Rule when those offerings are sold only to one or more of the following:

- Institutional accounts, as defined in NASD Rule 3110(c)(4);1
- Qualified purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940 (1940 Act);
- Qualified institutional buyers, as defined in the Securities Act of 1933 (Securities Act) Rule 144A;
- Investment companies, as defined in Section 3 of the 1940 Act;
- 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; and
- Employees and affiliates of the issuer.

Importantly, because sales to qualified purchasers would be exempt, the Proposed Rule would be inapplicable to 3(c)(7) funds.

Additionally, the Proposed Rule would exempt the following types of private placement offerings:

- Offerings of exempted securities, as defined by Section 3(a)(12) of the Securities Exchange Act of 1934 (Exchange Act);
- Offerings made pursuant to Securities Act Rule 144A or SEC Regulation S;
- Offerings of exempt securities with short term maturities under Section 3(a)(3) of the Securities Act;
- Offerings of subordinated loans under Exchange Act 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 Rule 5110(b)(8)(E);
- Offerings of non-convertible debt or preferred securities by issuers that meet the eligibility criteria for incorporation by reference in Forms S-3 and F-3;

1 This definition of “institutional accounts” will transfer to new FINRA Rule 4512(c) when that rule becomes effective on Dec. 5, 2011. The text of the Proposed Rule will be amended at that time to reflect the change.
> 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 under Section 1a(11) of the Commodity Exchange Act; and

> Offerings filed with FINRA under Rules 2310, 5110, 5121 and 5122.

Finally, members and their affiliates may apply for exemption from the Proposed Rule for good cause pursuant to the FINRA Rule 9600 Series.

The exemption in the list above for Regulation S offerings will be important for many offshore hedge funds. This is because many offshore hedge funds sell interests only to qualified purchasers in the U.S., but, based on SEC staff precedent, do not so limit their offshore sales. However, because the non-U.S. investors typically purchase their shares in Regulation S transactions, neither the sales to qualified purchasers in the U.S., nor the sales to non-U.S. persons would trigger a filing requirement.

**Confidentiality**

Under the Proposed Rule, FINRA would give confidential treatment to documents and information filed pursuant to the rule. FINRA would use the documents and information filed pursuant to the Proposed Rule to determine compliance with FINRA and other regulatory rules. FINRA would also accord confidential treatment to comment or similar letters by FINRA, which could not then be discoverable by a litigant through a legal action.

**Implementation Date**

FINRA plans to announce the implementation date for the Proposed Rule within 90 days of SEC approval and states that implementation will take place within 180 days of that approval.

**Investment Management Group**

For more information about the matters discussed in this article, please contact your regular Drinker Biddle lawyer or any member of our Investment Management Group.

**Partners, Of Counsel and Counsel**

- **Gary D. Ammon**  
  (215) 988-2981  
  Gary.Ammon@dbr.com

- **Bruce L. Ashton**  
  (310) 203-4048  
  Bruce.Ashton@dbr.com

- **John W. Blouch**  
  (202) 230-5422  
  John.Blouch@dbr.com

- **Stephen T. Burdumy**  
  (215) 988-2880  
  Stephen.Burdumy@dbr.com

- **Summer Conley**  
  (310) 203-4055  
  Summer.Conley@dbr.com

- **Mark F. Costley**  
  (202) 230-5108  
  Mark.Costley@dbr.com

- **Joshua B. Deringer**  
  (215) 988-2959  
  Joshua.Deringer@dbr.com

- **Bruce W. Dunne**  
  (202) 230-5425  
  Bruce.Dunne@dbr.com

- **Glenn E. Ferencz**  
  (312) 569-1246  
  Glenn.Ferencz@dbr.com

- **Stephen D.D. Hamilton**  
  (215) 988-1990  
  Stephen.Hamilton@dbr.com

- **Veena K. Jain**  
  (312) 569-1167  
  Veena.Jain@dbr.com

- **Michelle M. Lombardo**  
  (215) 988-2867  
  Michelle.Lombardo@dbr.com

- **Michael P. Malloy**  
  (215) 988-2978  
  Michael.Malloy@dbr.com

- **David M. Matteson**  
  (312) 569-1145  
  David.Matteson@dbr.com

- **Diana E. McCarthy**  
  (215) 988-1146  
  Diana.McCarthy@dbr.com

- **Nancy P. O’Hara**  
  (215) 988-2699  
  Nancy.OHara@dbr.com

- **Mary Jo Reilly**  
  (215) 988-1137  
  MaryJo.Reilly@dbr.com

- **Fred Reish**  
  (310) 203-4047  
  Fred.Reish@dbr.com

**Other Publications**

[Link to Sign Up](www.drinkerbiddle.com/publications/signup)