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FINRA Amends Proposed Private Placements Rule; SEC Takes Rare Step of Instituting Proceedings to Determine Whether to Approve or Disapprove; Rule proposal amendment precedes passage of the JOBS Act.

On January 20, 2012, the SEC announced that with respect to the FINRA's Proposed Rule 5123 (Private Placements of Securities) (the "Proposed Rule"), originally announced in October 2011[1] and amended on January 19, 2012 (the "Amendment"), it was soliciting comments and instituting proceedings to determine whether to approve or disapprove the Proposed Rule.[2] Comments submitted in response to the version to the Original Proposal criticized the rule as overbroad, as a hindrance to capital formation, and as contrary to the intent of Congress and the federal securities laws, insofar as the rule prescribes disclosures in respect of non-public offerings. The initial comment period with respect to the Amendment ended on February 27, 2012; some commenters continued in their objections to the Proposed

[1] For a detailed discussion of the Proposed Rule as announced in October 2011, you may wish to refer to our client publication, which is available at http://www.shearman.com/finra-seeks-to-expand-regulation-of-private-placements-10-31-2011/http://www.shearman.com/files/Publication/a176df0e-06f9-46cc-ace0-99f683e0d291/Presentation/PublicationAttachment/56a71736-9cf0-4a63-8fc3-aa48cebdedd4/FINRA-Seeks-to-Expand-Regulation-of-Private-Placements_FIA_103111.pdf. The October 2011 proposal was preceded by FINRA's January 2011 proposal to amend FINRA Rule 5122 (Private Placements of Securities Issued by Members) to apply to all private placements in which FINRA members participate. This proposal is discussed in our previous client publication, currently available at http://www.shearman.com/private-placement-update--finra-proposes-rule-amendments-to-require-filings-for-non-institutional-private-placements-03-02-2011/.

[2] SEC Release No. 34–66203, "*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) in the Consolidated FINRA Rulebook*" (Jan. 20, 2012), available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p125461.pdf. FINRA

Rule,[3] while other commenters suggested that the Amendment responded to concerns, and therefore supported adoption of the Amendment.[4]

I. The Proposed Rule After the Amendment

The Proposed Rule contains three principal elements: (i) a disclosure requirement, (ii) a filing requirement, and (iii) various exemptions, including for institutional private placements.

1.1 Disclosure Requirement

Proposed Rule 5123(a)(1) would require any FINRA member or person associated with a member selling any security in a nonpublic offering made in reliance on an available exemption from registration under the Securities Act ("private placement"), when a private placement memorandum, term sheet or other disclosure document ("disclosure document") is drafted by or on behalf of the issuer and used in connection with such sale, to provide such disclosure document to each investor to whom it sells the security prior to sale.

The use of the phrase "non-public offering in reliance on an available exemption from registration under the Securities Act" to describe the scope of the rule is a response to commenters' contention that the original phrase used ("security offered or sold by a member or associated person in reliance on an available exemption from registration under the Securities Act") was overbroad. Commenters noted that the Original Proposal's formulation would include any offer or sale of securities for which an exemption from registration is claimed under the Securities Act, even if such offering is outside the scope of Section 4(2) of the Securities Act. FINRA clarified that the formulation used in Amendment would exclude from the Proposed Rule's scope offerings of securities pursuant to the following provisions:

- Securities Act Sections 4(1), 4(3) and 4(4) (which generally exempt secondary transactions);
- Securities Act Sections 3(a)(2) (offerings by banks), 3(a)(9) (exchange transactions with an existing holder, where no person is paid to solicit the exchange), 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); or
- 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)).[5]

3 See, for example, the comment letter of the Managed Funds Association (Feb. 27, 2012), available at http://www.sec.gov/comments/sr-finra-2011-057/finra2011057-25.pdf.

4 See, for example, the comment letter of the Committee on Securities Regulation of the New York City Bar (Feb. 24, 2012), available at http://www.sec.gov/comments/sr-finra-2011-057/finra2011057-21.pdf.

5 FINRA letter to Elizabeth M. Murphy, US Securities and Exchange Commission, (Jan. 19, 2012), available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p125461.pdf.

Under the Proposed Rule, the disclosure document must include a description of the anticipated use of offering proceeds, the amount and type of offering expenses, and the amount and type of compensation provided or to be provided to sponsors, finders, consultants, and members and their associated persons in connection with the offering.[6]

The revised version of Proposed Rule 5123(a)(1) of the Amendment responds to concerns raised by commenters in respect of the Original Proposal that in private placements in which no offering document is used, FINRA members should not be required to have primary responsibility for preparing a disclosure document. The Amendment clarifies that the broker-dealer's obligations do not extend to drafting a disclosure document where none is used.

1.2 Filing Requirement

Propose Rule 5123(a)(3) requires that the disclosure document must be filed with FINRA either by each participating member (or by a member designated to make such filing on behalf of members identified in the filing) no later than 15 calendar days after the date of first sale. Any material amendments to the previously-filed disclosure document must be filed with FINRA no later than 15 calendar days after the date such document is provided to any investor.

In response to comments, the Amendment expressly permits FINRA members to designate a single FINRA member to file the disclosure document with FINRA.

1.3 Exemptions

The Proposed Rule would also provide various valuable exemptions to applicability, including exemptions for offerings sold exclusively to institutional and sophisticated investors. These exemptions are, based on either the type of purchaser or the type of offering. FINRA members continue to show concern for the outcome of after-the-fact reviews of offering materials, particularly since such reviews will be taking place following the completion of the applicable offering.

Exempt purchasers. The rule would exempt offerings sold to any one or more of the following types of purchasers:

- institutional accounts, as defined in NASD Rule 3110(c)(4);
- 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 of 1933 (the "Securities Act"), as amended;
- 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; and
- employees and affiliates of the issuer.

[6] Proposed Rule 5123(a)(2).

Exempt Offerings. Rule 5123 would also exempt the following types of offerings:

- offerings of exempted securities, as defined in section 3(a)(12) of the Securities Exchange Act of 1934, as amended (the "Exchange Act");
- offerings made pursuant to Rule 144A of the Securities Act 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 FINRA 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 eligibility criteria for incorporation by reference in Forms S-3 and F-3;
- 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 any of FINRA Rules 2310, 5110, 5121, and 5122.

1.4 Confidential Treatment

Proposed Rule 5123(d) provides that FINRA shall accord confidential treatment to all documents and information filed pursuant to the rule, and shall utilize such documents and information solely for the purpose of review to determine compliance with the provisions of applicable FINRA rules or for other regulatory purposes deemed appropriate by FINRA.

II. Continued Concerns with the Amendment; Impact of the JOBS Act

There continues to be concern with the Proposed Rule, despite the revisions contained in the Amendment. Some argue that the Proposed Rule is inconsistent with federal securities laws because it would mandate that issuers disclose particular information in connection with a private offering, and that with the Proposed Rule, FINRA is doing what the SEC itself has not done, i.e., establish a disclosure regime for private placements to sophisticated investors. Among other objections noted is the burden on capital-raising that the Proposed Rule would impose on hedge funds that rely on Sections 3(c)(1) and 3(c)(7) of the US Investment Company Act of 1940. Although other exemptions from the Proposed Rule may be available to such funds, commenters note that that determination would need to be conducted on a case-by-case basis.

One development that has taken place since the SEC's institution of proceedings in respect of the Proposed Rule is the enactment of the JOBS Act by Congress and by President Obama.[7] It remains to be seen whether the Proposed Rule will be further amended to exclude offerings exempted under new or expanded exemptions from registration enacted (or to be adopted) under the JOBS Act, and also whether the philosophy underlying the Proposed Rule, that of caution in relation to private offerings or securities, will fit consistently with the provisions of the JOBS Act that are designed to liberalize the private placement of securities, particularly by issuers.

III. Conclusion

With initial comments submitted to the SEC in respect of the Amendment, the broker-dealer and investment fund communities would be well-advised to be aware of SEC proceedings in respect of the Proposed Rule. The implementation of such proceedings is an infrequent development, and likely demonstrates SEC's concern and intention to progress with consideration, and possibly adoption, of this important expansion of FINRA's oversight of the private placement market.

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[7] For more information about the JOBS Act, you may wish to refer to "*JOBS Act Will Ease Rules for IPOs and Private Placements and Reduce Compliance Burdens Post IPO*", currently available at http://www.shearman.com/jobs-act-will-ease-rules-for-ipos-and-private-placements-and-reduce-compliance-burdens-post-ipo-03-2012, "*New Law Reduces Executive Compensation Disclosure Obligations and Eliminates Say-on-Pay Votes for Emerging Growth Companies*", currently available at http://www.shearman.com/new-law-reduces-executive-compensation-disclosure-obligations-and-eliminates-say-on-pay-votes-for-emerging-growth-companies-04-02-2012, and "*JOBS Act Creates Two New Exemptions from Broker-Dealer Registration*", currently available at, http://www.shearman.com/jobs-act-creates-two-new-exemptions-from-broker-dealer-registration-04-03-2012/. For an annotated reference guide to the JOBS Act, you may wish to refer to "*The JOBS Act: Changes to Existing Law / A Blackline and Annotated Reference Guide*", currently available at, http://www.shearman.com/the-jobs-act-changes-to-existing-law--a-blackline-and-annotated-reference-guide-03-2012.