SHEARMAN & STERLING LLP

FINANCIAL INSTITUTIONS ADVISORY & FINANCIAL REGULATORY

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FINRA Seeks to Expand Regulation of Private Placements

I. Introduction and Background

On October 4, 2011, the Financial Industry Regulatory Authority ("FINRA") filed with the Securities and Exchange Commission ("SEC") a proposed rule change to adopt the new FINRA Rule 5123 ("Rule 5123"), which would significantly expand the scope of FINRA's regulation over broker-dealer participation in private placements. Among other things, Rule 5123 would require that FINRA members and associated persons (a group including virtually all U.S.-registered broker-dealers) that offer or sell applicable private placements, or that participate in the preparation of private placement memoranda ("PPM"), term sheets, or other disclosure documentation in connection with private placements, provide disclosure to each investor prior to sale describing the anticipated use of proceeds, and the amount and type of offering expenses and offering compensation. Rule 5123 would further impose a notice filing requirement on member firms—a PPM, term sheet, or other disclosure document must, unless exempt under Rule 5123, be filed with FINRA no later than 15 days after the date of first sale. The scope of Rule 5123 is tempered by its various exemptions, which effectively limit its applicability to non-institutional private placements.

The purpose of Rule 5123 is two-fold: (i) to ensure that private placement investors are provided sufficiently detailed information about the intended use of proceeds, offering expenses, and offering compensation; and (ii) to provide FINRA with timely and detailed information about the private placement activities of member firms. FINRA initially sought to achieve these ends through amendment of the existing FINRA Rule 5122 (the "Proposed 5122 Amendments").[1] Proposed in January 2011, those amendments would have extended nearly all of the requirements of existing FINRA Rule 5122 ("Rule 5122") to all private placements in which a FINRA member participates. Rule 5122 requires FINRA members or associated persons participating in a private placement by a FINRA member or an entity that controls or is under common control with a FINRA member (a "Member Private Offering") to (i) disclose in the PPM the use of proceeds, offering expenses, and the amount of offering compensation to be paid to FINRA members; and (ii) file the PPM, term sheet, or other offering document with FINRA. Importantly, Rule 5122 also requires that at least 85% of the proceeds of a Member Private Offering be used for business purposes and that the use of the proceeds be consistent with the use of proceeds disclosed in the PPM, term sheet, or other offering document. As discussed below, an iteration of this requirement, included in the Proposed 5122 Amendments, has been struck from Rule 5123.

[1] For a detailed discussion of the Proposed 5122 Amendments, see our previous client publication, which is available at http://www.shearman.com/files/Publication/5ad7972c-4f03-49cc-8e6e-129c5f4bedeb/Presentation/PublicationAttachment/ceba8cb9-dc76-4733-8fb1-06dd1e39d260/FIA-030211-Private-Placement-Update.pdf.

While Rule 5123 must be formally adopted by the SEC before it can become effective, the current proposal provides insight into the basic parameters of forthcoming requirements for FINRA member firms in connection with their private placement activities.

II. Discussion

Rule 5123 contains three principal elements: (i) a disclosure requirement, (ii) a filing requirement, and (iii) exemptions.

Disclosure Requirement

Rule 5123 would prohibit any FINRA member firm or person associated with a member firm from offering or selling any security in a private placement or from participating in the preparation of a PPM, term sheet, or other disclosure document for such private placement, unless the FINRA member or associated person provides a PPM or term sheet to each investor prior to sale that describes 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 FINRA members and their associated persons in connection with the offering. This disclosure requirement generally tracks that of Rule 5122.

One aspect of the disclosure requirement raises some critical questions. If a private placement does not have a PPM or term sheet, then, absent an exemption, Rule 5123 would require a FINRA member to prepare a disclosure document that contains the required disclosures and provide that document to each investor prior to sale. On its face, Rule 5123 would require each FINRA member participating in a private placement to prepare and distribute to each investor such a disclosure document. While different disclosure documents prepared by each participating FINRA member would seemingly present liability risks, in practice, it is possible that multiple participating FINRA members would caucus to draft a single disclosure document. It would appear that this aspect of Rule 5123 would effectively require FINRA members to prepare a term sheet or PPM where the issuer has not taken the lead on doing so. Notably, producing their own disclosure and sales material may expose FINRA members to unaccustomed liability, and it is unclear who exactly would take responsibility for the accuracy of the disclosure document.

Filing Requirement

Rule 5123 would also impose a notice filing requirement on FINRA member firms participating in a private placement. Rule 5123 would require the PPM, term sheet, or other disclosure document, and any exhibits thereto, to be filed with FINRA no later than 15 calendar days after the date of first sale. Notably, Rule 5123 would require *each* FINRA member participating in an offering to make the requisite filing (one FINRA member cannot file on behalf of all members participating in the offering). The timing requirement represents a significant change from the initial proposal. The Proposed 5122 Amendments would have required the PPM, term sheet, or offering document to be filed prior or coincident to provision of such document to investors. In response to commenters' concerns regarding the potential hold-up of offerings due to this filing requirement, FINRA changed the timing requirement for the notice filing under Rule 5123 to no later than 15 days after the first sale, which is the same as the timing requirement for the filing of Form D.

The move to an *ex post*, or notice filing, requirement has important implications for FINRA members. First, the synchronized timing with the filing of Form D may allow FINRA members to achieve operational efficiencies, minor as they may be. More importantly, filing the offering document after first sale precludes any possibility that FINRA would provide comments on or require revision of the offering document prior to the launch or marketing of the offering. However, in the

past, FINRA has reserved the authority to make inquiries regarding notice filings that have been made. In this regard, neither Rule 5123 nor its accompanying release state that FINRA will not make further inquiry regarding notice filings made pursuant to Rule 5123.

The "85% Requirement"

One key provision of Rule 5122 is not part of Rule 5123 as currently proposed. Rule 5122 requires that at least 85% of the proceeds of a Member Private Offering be used for business purposes and that the use of the proceeds be consistent with the use of proceeds disclosed in the PPM, term sheet, or other offering document. The Proposed 5122 Amendments would have amended this provision of Rule 5122 to impose quite a heavy burden on member firms. The Proposed 5122 Amendments would have required that at least 85% of the offering proceeds raised be used for the business purposes described in the PPM, term sheet, or other offering document (the "85% Requirement"). Naturally, this provision drew the most attention during the comment period. The more notable concerns regarding this provision were that it would be difficult and burdensome for FINRA members to monitor an issuer's use of proceeds, the Proposed 5122 Amendments would impose burdens on or attempt to regulate non-FINRA members, and that the 85% Requirement was an arbitrary "one size fits all" approach which could be a barrier to capital formation and which could force issuers to explore alternative means of capital raising. Heeding these concerns, FINRA has removed the 85% Requirement from the proposed Rule 5123.

Exemptions

Rule 5123 would also provide various exemptions to its applicability, including valuable exemptions for offerings sold exclusively to institutional and sophisticated investors. These exemptions are bifurcated, based on either the type of purchaser or the type of offering. Namely, Rule 5123 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.

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 FINRA Rules 2310, 5110, 5121, and 5122.

The proposed exemptions are very similar to those in existing Rule 5122. The only differences are that Rule 5123 would not exempt (i) offerings in which a FINRA member acts in a wholesaling capacity and (ii) offerings of certain credit derivatives. Generally, the effect of the exemptions would be to limit the scope of the applicability of Rule 5123 to non-institutional, or retail, private placements.

Other Provisions

Rule 5123 contains provisions identical to those in Rule 5122 regarding confidential treatment and application for exemption. Under Rule 5123, FINRA would accord confidential treatment to all documents and information filed pursuant to Rule 5123 and would use such documents and information solely for determining compliance with FINRA rules or other applicable regulatory purposes. Rule 5123 would also provide FINRA members with a method for application for exemptions from the provisions of the rule for good cause pursuant to the Rule 9600 Series.

III. Timing and Implementation

Before Rule 5123 can become effective, there remain a few procedural and administrative hurdles to clear. The SEC must approve the rule, after which FINRA would issue a regulatory notice announcing its implementation date no later than 90 days following SEC approval. The implementation date would be no later than 180 days following SEC approval.

IV. Conclusion

Rule 5123 would effectively expand the scope of Rule 5122 beyond Member Private Placements to include all non-institutional private placements. While Rule 5123 would expand the scope regulatory compliance required of FINRA member firms in connection with their private placement activities, Rule 5123 represents significant improvement for member firms from the initially proposed amendments to Rule 5122. Notably, the striking of the 85% Requirement and the change in the timing of the filing requirement from prior or coincident to provision of the offering document to investors to no later than 15 days after the first sale are changes from the initial proposal that FINRA members will welcome.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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