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FINRA Revises its Proposal on Private Placements

The Financial Industry Regulatory Authority (FINRA) has proposed new Rule 5123 (Private Placements of Securities), which would require FINRA member firms (“members”) to provide investors in private placements with detailed information about the intended use of proceeds of the private placement, including offering expenses and compensation of members. Members would also be required to file a copy of such disclosure with FINRA after sales are first made to investors. The proposed rule would apply to private placements by all issuers, other than members and their affiliates; members and their affiliates are subject to equivalent obligations under Rule 5122.

The proposed rule would be effective no later than 180 days after SEC approval.

Background

Rule 5122. Rule 5122, which became effective in June 2009, was designed to prevent abuses in private placements of securities issued by broker-dealers. That rule requires a member or associated person that engages in a private placement of unregistered securities issued by the member (or a control entity of the member) to:

- disclose to investors, in a private placement memorandum, term sheet or other offering document (“Offering Materials”), the intended use of offering proceeds and the offering expenses,
- file the offering document with FINRA at or prior to the time it is first provided to any investor, and
- commit that at least 85% of the offering proceeds would be used for business purposes, which may not include offering costs, discounts, commissions or any other cash or non-cash sales incentives.

January 2011 Proposal. In January 2011, FINRA proposed amendments to broaden the scope of Rule 5122. The January proposal would have extended Rule 5122’s requirements relating to disclosure, filing and limitations on the use of offering proceeds to all private placements in which a member participates, and not just those in which the member (or its control entity) is the issuer.

The proposal was intended to enhance investor protections in connection with private placements and assist in FINRA’s efforts to identify problematic terms and conditions in private placements, thereby helping to detect and prevent fraud.

The proposal was subject to significant criticism, which focused particularly on the use of offering proceeds commitment and the filing requirement. With respect to the 85%-requirement, FINRA recognized that an across-the-board application of this limit could impose unnecessary burdens on some offerings, and that its concerns regarding the use of offering proceeds could be addressed through obligations already imposed on broker-dealers (under the suitability and anti-fraud provisions of the securities laws and FINRA rules).

Rather than expand Rule 5122, FINRA proposed Rule 5123, and opted to omit the use of proceeds commitment. FINRA also modified the notice requirement to apply after the first sale (as described below), thus making clear that the notice requirement is not a precondition to commencing an offering.

Proposed Rule 5123

Disclosure Requirements. Proposed Rule 5123 would prohibit a member or person associated with a member from offering or selling any security in reliance on an available exemption from registration (defined as “private placement”) under the U.S. Securities Act of 1933 (the “Securities Act”), or participating in the preparation of Offering Materials for a private placement, unless the member or associated person provides Offering Materials 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 members and their associated persons in connection with the offering.

For a private placement that does not include Offering Materials, the proposed rule would require members to prepare a document that contains the required disclosures and provide it to investors prior to sale.

“Notice” Filing Requirement. The proposed rule would require members to file a copy of the Offering Materials (including exhibits) with FINRA no later than 15 calendar days after the date of first sale. It would also require the members to file with FINRA any material amendments to those materials, or any amendments to the information disclosed to FINRA, no later than 15 calendar days after the date revised Offering Materials are given to any investor or prospective investor.

Each member that participates in a private placement would be required to make the requisite filing. Where multiple members are involved in the same private placement, each member would need to make its own filing.

Exemptions. The proposed rule exempts offerings sold to certain purchasers and certain types of offerings, most of which are similar to those included in Rule 5122.

The exemptions based on the type of purchaser include offerings sold only to any one or more of the following 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 of 1940 (the “1940 Act”);
- qualified institutional buyers (“QIBs”), as defined in Rule 144A promulgated under the Securities Act (“Rule 144A”), or an entity owned exclusively by QIBs;
- investment companies, as defined in Section 3 of the 1940 Act;
- banks, as defined in Section 3(a)(2) of the Securities Act; and
- issuer employees and affiliates.

The exemptions based on the type of offerings include, among others:

- offerings made pursuant to Rule 144A or Regulation S promulgated under the Securities Act (as such the proposed rule would apply to Regulation D and Section 4(2) offerings to accredited investors, unless otherwise exempt);
- offerings of exempted securities, as defined in Section 3(a)(12) of the U.S. Securities Exchange Act of 1934;
- offerings of exempt securities with short-term maturities under Section 3(a)(3) of the Securities Act (*i.e.*, commercial paper);
- offerings of non-convertible debt or preferred securities by issuers that meet the eligibility criteria for incorporation by reference in SEC Forms S-3 and F-3;
- offerings of securities issued in conversions, stock splits and restructuring transactions that to existing investors without the need for additional consideration or investments on the part of the investors;
- offerings subject to FINRA filing requirements under its suitability rule (Rule 2310), corporate financing rule (Rule 5110), conflicts of interest rule (Rule 5121); and
- private placements by members (Rule 5122).

The proposed rule contemplates applications for exemptions from the provisions of the rule for “good cause.”

FINRA would afford confidential treatment to all Offering Materials and other information filed pursuant to the rule, and would use these materials only for the purpose of determining

compliance with FINRA rules or other applicable regulatory purposes. The proposed rule would also afford confidential treatment to comment or similar letters sent by FINRA.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to:

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