PRYOR CASHMAN LLP

LEGAL UPDATE

October 2012 *By: Stephen M. Goodman, Bertrand C. Fry and Michael T. Campoli*

FINRA PILES IT ON: PRIVATE PLACEMENTS TO WEALTHY INDIVIDUALS TRIGGER FINRA FILING REQUIREMENTS

Beginning December 3, 2012, when a member of the Financial Industry Regulatory Association ("FINRA")[1] acts as placement agent for a non-member[2] issuer that is conducting a private placement of its securities, the member will be required, in many instances, to file the issuer's private placement memorandum, term sheet, or other offering documents with FINRA within 15 days after the date of the first sale by such member of the offered securities, or to indicate to FINRA by a notice filing that no offering documents were used.[3] This is the latest in a series of notices that reflect FINRA's increasing concern with the private placement process and, as discussed below, is likely to have particular impact on private placements targeting non-institutional accredited investors.

As noted in a February 2011 Pryor Cashman Legal Update,[4] over the last several years, efforts by the Securities and Exchange Commission ("SEC") to rein in unregistered brokers engaged in private placement activity have been complemented by a shift in FINRA's approach toward regulating the activities of its members in connection with private placements. Its first action,[5] in June 2009, was to adopt Rule 5122, which required any FINRA member firm and any of its associated persons engaged in a private placement of that firm's securities or those of a control entity to comply with certain disclosure and filing requirements and limitations on the use of proceeds.[6]

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[1] Section 15(a)(1) of the Securities Exchange Act of 1934 (the "Exchange Act") and the related SEC regulations require substantially all securities brokers to register as "members" of FINRA. References in this Legal Update to "members" are to members of FINRA.

[2] Private placements of unregistered securities issued by FINRA members or issuers that control or are under common control with a member, or are controlled by a member or its associated persons, are governed by FINRA Rule 5122.

[3] Regulatory Notice 12-40, *Private Placements of Securities* (September 2012), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p163707.pdf. Such an offering is defined in Rule 5122 as a "member private offering" or "MPO".

[4] *Legal Update: FINRA Seeks to Monitor Broker Compensation in Non-Member Private Offerings Through Pre-Filing Requirement* (February 16, 2011), available at http://www.pryorcashman.com/news-publications-105.html.

[5] Prior to the adoption of Rule 5122, FINRA had not specifically regulated private placements, given that (according to the notice) FINRA's then-existing rules generally applied only to public offerings.

[6] Regulatory Notice 09-27, *Member Private Offerings* (June 2009), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118735.pdf. A "control entity" is defined in Rule 5122 to mean "any entity that controls or is under common control with a member, or that is controlled by a member or its associated persons." Rule 5122's definition of "control" turns on the applicable entity's having a beneficial interest of more than 50 percent of the outstanding voting securities of a corporation, or the right to more than 50 percent of the distributable profits or losses of a partnership or other non-corporate legal entity. Consequently, the power to direct the

Then, in response to numerous reports of abusive practices in private placements, evidenced by a significant increase in enforcement actions brought both by the SEC and FINRA, FINRA issued Regulatory Notice 10-22[7] reminding broker-dealers that FINRA rules require each member recommending securities offered in a private placement to conduct a "reasonable investigation" of those securities and their issuer, even if the securities are offered only to accredited investors in Regulation D transactions. The notice also pointed out that FINRA members are required to keep records of any such investigation, in part to support the discharge of the member's additional responsibility to determine the "suitability" of the investment for investors. The notice also posited that private placement offering documents and other sales material that a broker-dealer distributes are generally considered communications with the public for purposes of, and thus subject to, FINRA's advertising rules.[8]

FINRA then determined that further regulation of the private offering process was warranted. As discussed in our prior Legal Update, in January 2011, FINRA proposed amendments to amend Rule 5122 (previously applicable only to private offerings by member firms and their affiliates) to extend its provisions to private placements by non-member firms as well.[9] Among the proposals were requirements that private offering documents for non-member issuers be filed in advance of their initial sale so that FINRA could monitor broker-dealer compensation as well as the content of certain disclosures.

This proposed amendment to Rule 5122 evolved into the new Rule 5123 (the "Rule") after several iterations. The Rule, as finally approved by the SEC, is considerably less burdensome than some of the earlier proposals. However, it retains the obligation imposed on member firms to file offering and sales materials used in private placements, particular where the purchasers are individuals rather than institutions.

FILING REQUIREMENT

The general requirement articulated in the Rule is that each member firm that sells a security in a private placement must file a copy of any offering document used in that offering with FINRA within 15 calendar days of the date of the first sale by such member.[10] Furthermore, if the private placement is conducted without an offering document, the member must provide notice to FINRA within that time period that no such document was used. The filings will be considered "notice" filings and therefore FINRA will not comment on or issue clearances regarding the filing.

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management or policies of a corporation or partnership or other non-corporate legal entity (*e.g.*, the authority typically held by a general partner of a limited partnership or a manager of a limited liability company) taken by itself would not constitute "control."

[7] *Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings,* available at http://www.finra.org/Industry/Regulation/Notices/2010/P121299.

[8] NASD Rule 2210 (Communications with the Public), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3617 sets out certain rules for the content of communications with the public, including that "[a]ll member communications with the public . . . must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading." Effective February 4, 2013, this and other related NASD rules will be replaced by new FINRA Rule 2210 and other rules providing similar but more specific directives regarding the content of such communications. See SR-FINRA-2011-035, *Proposed Rule Change to Adopt FINRA Rules Regarding Communications with the Public in the Consolidated FINRA Rulebook* available at http://www.finra.org/Industry/Regulation/RuleFilings/2011/P123894.

[9] Regulatory Notice 11-04, *Private Placements of Securities* (January2011), available at *http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122787.pdf*.

[10] A firm may submit a filing on behalf of other firms involved in the sale of the private placement, provided that, as part of the submission, the firm identifies the other firms on whose behalf it is making the filing.

Filings must be made in searchable PDF format and submitted electronically through FINRA's Firm Gateway. However, as with filings made under Rule 5122, the filings will be treated as confidential.

EXEMPTIONS FROM THE FILING REQUIREMENT

Generally

The Rule will not apply to offerings of certain specified securities, such as exempted securities under Section 3(a)(12) of the Exchange Act, offerings made pursuant to Rule 144A under the Securities Act of 1933 (the "Securities Act") or purely offshore offerings made pursuant to the SEC's Regulation S. Offerings of various types of debt securities, annuity contracts, securities of commodity pools operated by commodity pool operators, securities of registered investment companies and standardized options are also exempt. In addition, no filing is required under the Rule if the securities being privately placed are sold *solely* to certain specified types of sophisticated purchasers, including banks, insurance companies, investment advisers registered with the SEC under the Investment Advisers Act of 1940 or a state securities commission, any other person with total assets of at least $50 million, "eligible contract participants" under the Exchange Act, "qualified purchasers" under the Investment Company Act of 1940 (the "Investment Company Act"), "investment companies" under the Investment Company Act, "qualified institutional buyers" under Rule 144A ("QIBs") and entities consisting entirely of QIBs,. Private placements sold by a member or associated person remain exempt from the Rule if they are also sold to (or are sold solely to) employees and affiliates of the issuer and "knowledgeable employees" under the Investment Company Act.

A member will be exempt from the Rule so long as all of the sales made by such member qualify for an exemption, even if other members make sales that are not exempt (and thus result in such other members' being required to comply with the filing and other requirements of the Rule).

Accredited Investors: Special Case

The foregoing discussion does not set out an exhaustive list of the available exemptions. However, there is one prominent omission from the list of transactions that are not subject to the Rule. Offerings made to "accredited investors" (as defined in Rule 501 of Regulation D) will be exempt only if the purchasers are accredited investors under certain clauses of Regulation D.[11] Consequently, unless another exemption applies, the Rule will still require that offering documents be filed (or a notice filing made) if the purchasers in the private placement include individuals who are accredited only because they meet annual income or net worth tests of the definition or because they are directors, executive officers, or general partners of the issuer of the securities or of a general partner of that issuer.[12] Similarly, the Rule will also continue to apply if any of the purchasers qualifies as an accredited investor only because it is an entity in which all of the equity owners are accredited investors.[13]

It therefore appears that a significant purpose of the rule is to give FINRA the ability to monitor compliance with the member obligations set forth in Regulatory Notice 10-22[14] regarding "reasonable investigation" and "suitability". The filing requirement must be read in light of statements in that notice that "[t]he fact that a [broker-dealer's] customers may be sophisticated and knowledgeable does not obviate the duty to investigate."

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[11] Specifically, accredited investors described in Rule 501(a)(1), (2), (3) or (7).

[12] If the issuer is a "Covered Company" (a private investment fund excluded from registration under the Investment Company Act under Section 3(c)(7)) then these "executive officers, directors, and general partners" would be "knowledgeable employees," and the exemption from the Rule for private placements to knowledgeable employees, referred to above in the text, may apply

[13] It is unclear whether that FINRA would apply the Rule to an entity the owners of which are all accredited investors under Rule 501(a)(1), (2), (3), or (7).

[14] See footnote 8 above.

As noted above, Regulatory Notice 10-22 also stresses that private placement sales material that a broker-dealer distributes will generally be considered communications with the public for purposes of FINRA's Rule 2210 (governing advertising) and that "[i]f a private placement memorandum or other offering document presents information that is not fair and balanced or that is misleading, then the [broker-dealer] that assisted in its preparation may be deemed to have violated [FINRA] Rule 2210… ."

EXCLUSIONS

The Rule applies only to members that sell the privately placed securities of the non-member issuer. A member is not required to comply with the Rule with respect to private placements in which the member's involvement does not extend beyond providing advisory, consulting or administrative services for the issuer or in connection with the private placement.[15]

LIABILITY FOR VIOLATIONS

FINRA has expressly declined to clarify the penalties that will be imposed on a member that violates the Rule. Rather, FINRA's view is that, as for any violation of a FINRA rule by a member, a wide range of regulatory responses is available for violations of the Rule, with the specific penalties to be levied determined by FINRA based on its evaluation of the facts and circumstances of the particular violation. Under FINRA Rule 9370, a member that is subject to a penalty under the Rule may apply for review of the penalty by the SEC.

APPLICATION TO PRIVATE INVESTMENT FUNDS

As ultimately adopted, the impact of the Rule on the private placement of private investment funds that rely on an exclusion from the registration requirements under Section 3(c)(1) or Section 3(c)(7) under the Investment Company Act (which includes most hedge funds and private equity funds) is limited. Nonetheless, there are situations in which the Rule will apply.

Private investment funds that rely on Section 3(c)(7) can expect to fall easily into exemptions from the Rule based on their being offered solely to "qualified purchasers" and "knowledgeable employees" under the Investment Company Act. In contrast, funds relying on Section 3(c)(1), which are not required to so limit their investors, will generally be subject to the Rule to the extent that they are either affiliated with, or use in their placement, a registered broker-dealer and they issue their securities to natural persons or "high net worth" investors.

Such Section 3(c)(1) funds may find, however, that they are able to rely on the exemption for private placements of securities of a commodity pool operated by a "commodity pool operator" ("CPO") as defined under Section 1a-(11) of the Commodity Exchange Act. This definition of CPO includes any person who meets the functional test set out therein and is registered with the Commodity Futures Trading Commission as a CPO. With the elimination, effective as of December 31, 2012, of the exemption from CPO registration previously available under CFTC Rule 4.13(a)(4), many Section 3(c)(1) funds will find that their managers will be required to register as CPOs, with the aim of seeking to be subject to the relatively lighter regulatory requirements under CFTC Rule 4.7. On the other hand, managers that are able to rely on the exemption from registration under CFTC Rule 4.13(a)(3) (the "de minimis" test) will find that FINRA has not extended the Rule's exemption for commodity pools to their private investment funds.

CONCLUSION

Given what appears to be increased scrutiny of broker-dealer involvement in the private placement markets, the filing requirement imposed by the Rule should not simply be regarded as a mechanical step in ensuring compliance with the minutiae of the overall regulatory framework. Should the offering materials prove to

[15] Letter from Stan Macel, FINRA, dated January 19, 2012, available at http://www.sec.gov/comments/sr-finra-2011-057/finra2011057-18.pdf.

contain material misstatements or omissions, be something other than "fair and balanced" within the advertising rule or otherwise provide evidence that the security offered was "unsuitable" for a particular individual investor, a member firm could face fines or other disciplinary action. Therefore, if a member firm has not already instituted procedures to ensure compliance with the obligations spelled out in Regulatory Notice 10-22, the new Rule 5123 should offer a strong incentive to adopt such procedures.

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The foregoing is merely a discussion of FINRA's new Rule 5123. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Stephen M. Goodman at 212-326-0146 or sgoodman@pryorcashman.com, Bertrand C. Fry at 212-326-0134 or bfry@pryorcashman.com, or Michael T. Campoli at 212-326-0468 or mcampoli@pryorcashman.com.