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New FINRA Rule 5123 Imposes Filing Obligation for Certain Private Placements

New FINRA Rule 5123 will require each FINRA member that sells a security in a private placement, subject to certain exemptions, to file with FINRA a copy of any private placement memorandum, term sheet or other offering document used in connection with such private placement within 15 calendar days after the date of the first sale, or to indicate to FINRA that no such offering documents were used. Due to the exemptions, the regulatory burden of this new requirement will fall primarily on offerings of Section 3(c)(1) private investment funds and other offerings made to individuals or retail investors. A copy of FINRA Regulatory Notice 12-40 (September 2012) (Private Placements of Securities) is available here.

Background

Historically, FINRA Rule 5122 has required FINRA members that issue their own securities in a private placement to file with FINRA a copy of the offering documents used in connection with such issuance. Private placements of hedge funds and private equity funds sponsored by a FINRA member (and in which an affiliate of the FINRA member serves as the general partner) generally are not subject to the filing and other requirements of FINRA Rule 5122 unless the FINRA member also holds more than 50 percent of the fund's voting securities after closing of the fund or the FINRA member otherwise has "control." In January 2011, FINRA proposed extensive amendments to Rule 5122 to cover not only member private offerings but also any private placement in which a FINRA member participates.[1] In October 2011, FINRA changed course — abandoning its January 2011 proposed changes to Rule 5122 — and instead proposed new Rule 5123 requiring FINRA members that sell securities in a private placement to file with FINRA the offering documents used in connection with such private placement. FINRA has since released three amendments to proposed Rule 5123, the most recent of which was released in March 2012. On June 7, 2012, the Securities and Exchange Commission approved proposed Rule 5123, as amended, on an accelerated basis.

Notice Filing Requirement

Subject to certain exemptions described below, Rule 5123 requires each FINRA member that sells securities in a private placement to:

- Submit to FINRA, or have submitted on its behalf by a designated member, a copy of any private placement memorandum, term sheet or other offering document, including any materially amended versions thereof, used in connection with such private placement within 15 calendar days after the date of first sale; or

- Indicate to FINRA that no such offering documents were used.

[1] *See* FINRA Regulatory Notice 11-04 (January 2011) (Private Placements of Securities).

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FINRA noted in its Regulatory Notice 12-40 that this 15-day time period for filing tracks the filing requirement for Form D.

Notably, this requirement was significantly modified from the original proposal in response to comments from industry participants. In the final rule, FINRA eliminated certain disclosure requirements as well as the original proposal requiring the creation of a disclosure document containing such disclosures even if one had not been intended to be used.

The required documents must be filed through the FINRA Firm Gateway. FINRA is developing a private placement filing system to receive the offering documents required to be filed under Rule 5123. Filings of member firm private offerings under Rule 5122 also will be filed using the new system. Since both Rule 5123 and Rule 5122 filings will be considered notice filings, FINRA will not respond to the filings with a comment letter or a clearance letter.

FINRA will give confidential treatment to all documents and information filed pursuant to Rule 5123, and will utilize such documents and information solely for the purpose of review to determine compliance with the provisions of applicable FINRA rules or for other appropriate regulatory purposes.

Exemptions from the Notice Filing Requirement

Rule 5123 includes a number of exemptions from the notice filing requirement, including:

- Offerings sold by the FINRA member or person associated with the FINRA member solely to any one or more of the following:
  - institutional accounts, as defined in FINRA Rule 4512(c);
  - qualified purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940 (as amended, the "Investment Company Act");
  - qualified institutional buyers, as defined in Rule 144A under the Securities Act of 1933 (as amended, the "Securities Act");
  - investment companies, as defined in Section 3 of Investment Company Act;
  - an entity composed exclusively of qualified institutional buyers, as defined in Rule 144A;
  - banks, as defined in Section 3(a)(2) of the Securities Act;
  - employees and affiliates, as defined in FINRA Rule 5121, of the issuer;
  - knowledgeable employees as defined in Rule 3c-5 of the Investment Company Act;
  - eligible contract participants, as defined in Section 3(a)(65) of the Securities Exchange Act of 1934 (as amended, the "Exchange Act"); and
  - accredited investors described in Rules 501(a)(1), (2), (3) or (7) under the Securities Act.[2]

[2] Notably, this exemption includes only certain specified institutional accredited investors and does not apply to offerings to accredited investors that are natural persons as described in Rules 501(a)(4), (5), (6) or (8) under the Securities Act.

- Exemptions based on the type of offerings include:
  - offerings of exempted securities, as defined in Section 3(a)(12) of the Exchange Act;
  - offerings made pursuant to Rule 144A or Regulation S under the Securities Act;
  - offerings of exempt securities with short-term maturities under Section 3(a)(3) of the Securities Act and debt securities sold by members pursuant to Section 4(a)(2) of the Securities Act so long as the maturity does not exceed 397 days and the securities are issued in minimum denominations of $150,000 (or the equivalent thereof in another currency);
  - offerings of subordinated loans under Exchange Act Rule 15c3-1, Appendix D[3];
  - 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 nonconvertible debt or preferred securities by issuers that meet the transaction eligibility criteria for registering primary offerings of nonconvertible securities on 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;
  - business combination transactions as defined in Rule 165(f) under the Securities Act;
  - offerings of registered investment companies;
  - standardized options, as defined under Rule 238 under the Securities Act; and
  - offerings filed with FINRA under Rules 2310, 5110, 5121 and 5122, or exempt from filing thereunder in accordance with Rule 5110(b)(7).

In addition, members may apply for an exemption on the basis of "good cause" shown.

Effective Date

Rule 5123 will become effective December 3, 2012, and applies prospectively to private placements that begin selling efforts on or after that date.

Impact

The new rule reflects FINRA's continued focus on broker-dealer activities in connection with the marketing of private investment funds, particularly to investors who are not qualified purchasers. FINRA historically has placed greater restrictions on marketing materials used with investors in Section 3(c)(1) funds (who

[3] *See* NASD Notice to Members 02-32 (June 2002).

typically do not qualify as "qualified purchasers").[4] Offerings of private fund interests made only to qualified purchasers and knowledgeable employees are exempt from the filing requirements in new Rule 5123, so offerings of Section 3(c)(7) funds in which a FINRA member serves as placement agent should not trigger a filing requirement or significant additional compliance burdens. But offerings of Section 3(c)(1) fund interests in which individual accredited investors participate will trigger the filing requirement. As a result, small and midsized fund advisers and fund advisers with plans to raise a Section 3(c)(1) fund through an offering to individual accredited investors should plan for the additional compliance burden and filing of their offering materials by any placement agent involved in the offering.

In addition, FINRA has reminded broker-dealers of their due diligence obligations in Regulation D private placements and emphasized that a broker-dealer assisting in the preparation of a private placement memorandum or other offering document should expect that it will be considered a communication with the public by the broker-dealer for purposes of NASD Rule 2210.[5] FINRA members involved in such private placements should continue to focus on the offering materials used in such offerings in light of the new rule and FINRA's prior pronouncements regarding their due diligence obligations in connection with private placements.

Additional Information

The Hunton & Williams Private Investment Fund practice group regularly represents funds, sponsors and a variety of investors in all types of private investment fund matters, including structuring, formation, offerings and compliance. We will continue to monitor the progress of the requirements relating to investment advisers as well as relevant trends in private investment fund regulation.

For additional information on financial industry proposals, see our related memoranda, available on www.huntonfinancialindustryresourcecenter.com. For additional information on recent proposals relating to regulation of private investment funds and their advisers, see our prior memoranda available on our website at www.hunton.com.

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[4] *See*, e.g., FINRA Interpretive Letter to Budge Collins, dated September 14, 2004 ("NASD staff will not permit [the member] to distribute related performance information to potential investors in 3(c)(1) funds, even where such related performance information would be distributed only to QIBs."); FINRA Interpretive Letter to Yukako Kawata, dated December 30, 2003 ("the NASD staff would not object if a member includes related performance information in sales material for Section 3(c)(7) funds, provided that the member ensures that all recipients of such sales material are 'qualified purchasers' under Section 2(a)(51) of the 1940 Act.")

[5] *See* FINRA Regulatory Notice 10-22 (April 2010) (Regulation D Offerings: Obligations of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings).