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Client**Alert**

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FINRA Announces Effective Date for Rule 5123—Private Placements of Securities

On September 5, 2012, the Financial Industry Regulatory Authority ("FINRA") issued a regulatory notice informing members that new FINRA Rule 5123—Private Placements of Securities, which was approved by the Securities and Exchange Commission ("SEC" or the "Commission") on June 7, 2012, will take effect on December 3, 2012, and will apply prospectively to private placements that begin selling efforts on or after that date.[1] In light of the impending implementation date, this Client Alert reviews the requirements of the rule, which will impact both FINRA member firms and certain companies raising capital in private placements.[2]

Overview of Rule 5123

Subject to broad exceptions discussed below, Rule 5123 requires each FINRA member firm that sells an issuer's securities in a private placement to file with FINRA a copy of any private placement memorandum ("PPM"), term sheet or other offering document the firm used within 15 calendar days of the date of the sale, or indicate to FINRA that it did not use any such offering documents. The rule requires firms to file any materially amended versions of the documents originally filed. Firms must file the required offering documents or provide the notification electronically with FINRA through the FINRA Firm Gateway.

Prior to the adoption of FINRA Rule 5123, FINRA required only FINRA members or their affiliates that issued their own securities in a private placement to file a copy of the PPM under Rule 5122—Private Placements of Securities Issued by Members. Rule 5123 effectively extends this obligation to non-member offerings subject to broad exceptions.

Definition of Private Placement and Impact of the Exemptions

A private placement is defined in Rule 5123 as "a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act." The rule exempts a broad range of private placements from this definition based on the type of purchaser, the type of offering or the type of security. A detailed list of the exemptions is set forth in Appendix A (exempt purchasers), Appendix B (exempt offerings) and Appendix C (exempt securities) to this Client Alert. The rule also permits FINRA member firms to apply for an exemption for good cause.

Monica Arora
Partner, New York
+ 1 212 819 8668
marora@whitecase.com

Colin Diamond
Partner, New York
+ 1 212 819 8754
cdiamond@whitecase.com

Sean O'Malley
Partner, New York
+ 1 212 819 8579
somalley@whitecase.com

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
United States
+ 1 212 819 8200

The breadth of the exemptions are such that only a limited range of private placements will be captured within the new rule. For example, private placements to most institutional accredited investors or to qualified institutional buyers, or private placements conducted pursuant to Regulation S, are exempted from Rule 5123. The net result is that offerings to individual accredited investors or pursuant to the exemption for up to 35 unaccredited investors under Regulation D are likely to trigger the filing requirement unless those individual accredited investors fall within another exemption or the offering or security is exempt. It should be noted in particular that a private fund relying on Section 3(c)(1) of the Investment Company Act in which individual accredited investors participate will not fall within an exemption and FINRA members involved in the sale of such securities should plan for compliance with the additional filing requirements.

Additionally, FINRA continues to emphasize its views regarding FINRA member firm due diligence obligations in Regulation D private placements. FINRA member firms are reminded that they must conduct thorough due diligence of both the issuer conducting a private offering and the terms of the offering itself. Failure to conduct thorough due diligence "could constitute a violation of the antifraud provisions of the federal securities laws and, particularly, Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder." [3]

FINRA emphasized that a wide range of regulatory responses is available for violations of FINRA Rule 5123, as is the case for violations of any FINRA rule. The regulatory response depends on the facts and circumstances of the violation, and any sanction imposed is subject to oversight and review by the SEC.[4]

Notice Filings

Filings under FINRA Rules 5122 and 5123 are "notice" filings, meaning that FINRA will not respond to the filings with a comment letter or provide a clearance letter. Any disclosure document used in the private placement containing information about proceeds, expenses and compensation must be filed with FINRA. If none, a member must still file with FINRA within the filing deadline a notice identifying the private placement and the participating members, stating that no disclosure document was used. FINRA has noted that (1) the notice filing requirement does not establish any review and approval process by FINRA for private placements, (2) each member participating in an offering (or a member's designee) is required to file the disclosure document with FINRA, (3) the filing requirement refers to the first sale by the member making the filing (or on whose behalf a designated member is filing), rather than the first sale by another member, and (4) FINRA does not require the member to make any additional disclosure to investors in such offerings.

Private Placement Filing System

On December 3, 2012, the new private placement filing system FINRA has been developing will become operational to receive the offering documents or notifications that firms must file under FINRA Rules 5122 and 5123. The filing system, which can be accessed through the FINRA Firm Gateway, will allow electronic submissions of the filings in searchable Portable Document Format (PDF) to FINRA. One firm can submit a filing on behalf of other firms involved in the sale of the private placement but must identify the other firms as part of its submission.

Confidential Treatment

Similar to Rule 5122, FINRA will accord confidential treatment to all documents and information filed pursuant to Rule 5123 and utilize the documents and information for the purpose of review to determine compliance with the provisions of applicable FINRA rules or for other regulatory purposes deemed appropriate by FINRA.

1 The notice can be found at the following hyperlink: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p163707.pdf.

2 Rule 5123 is not applicable to non-US broker-dealers who are not FINRA members.

3 FINRA Regulatory Notice 10-22 (April 2010) (Regulation D Offerings: Obligations of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings) available at www.finra.org/Industry/Regulation/Notices/2010/P121304.

4 *See* Letter from Stan Macel, FINRA, to Elizabeth Murphy, Secretary, SEC, dated January 19, 2012, available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p125430.pdf, and Letter from Stan Macel, FINRA, to Elizabeth Murphy, Secretary, SEC, dated March 12, 2012, available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p125798.pdf.

Appendix A – Exempt Purchasers

If the private placement is limited to participation by the following types of purchasers, then it will not be subject to FINRA Rule 5123:

Type of Purchaser	Source of Definition	Definition
Certain Accredited Investors	Securities Act Rule 501(a)(1), (2), (3) or (7) of Regulation D	Exempt "accredited investors" consist of (i) certain defined institutions, including a bank, a savings and loan association, a broker or dealer, an insurance company, an investment company, a business development company, a small business investment company, a plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, with total assets in excess of US$5 million, or certain employee benefits plans; (ii) a private business development company; (iii) a charitable organization, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of US$5 million; or (iv) any trust, with total assets in excess of US$5 million, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Regulation D.
Qualified Institutional Buyers ("QIBs")	Securities Act of 1933, as amended (the "Securities Act") Rule 144A	"Qualified institutional buyer" is defined as one of a number of entities that purchases the relevant securities for its own account or the accounts of other QIBs and that in the aggregate owns or invests on a discretionary basis at least US$100 million in securities of issuers that are not affiliated with that entity. Also included are registered broker-dealers owning and investing, on a discretionary basis, US$10 million in securities of non-affiliates.
Institutional Accounts	FINRA Rule 4512(c)	"Institutional account" means the account of (i) a bank, savings and loan association, insurance company, registered investment company, (ii) an investment adviser registered with the SEC or with a state securities commission, or (iii) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least US$50 million.
Qualified Purchasers ("QPs")	Investment Company Act Section 2(a)(51)(A)	''Qualified purchaser'' means (i) any natural person (including any person who holds a joint, community property or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) with that person's qualified purchaser spouse) who owns not less than US$5 million in investments, as defined by the Commission; (ii) any company that owns not less than US$5 million in investments and that is owned directly or indirectly by or for two or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons; (iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or (iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than US$25 million in investments.
Investment Companies	Investment Company Act Section 3	*See* Investment Company Act and rules thereunder.
Entities Composed Exclusively of QIBs	Securities Act Rule 144A	*See* definition of QIB above.
Banks	Securities Act Section 3(a)(2)	"Bank" means any national bank, or any banking institution organized under the laws of any State, territory or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official; except that in the case of a common trust fund or similar fund, or a collective trust fund, the term ''bank'' has the same meaning as in the Investment Company Act of 1940.
Employees and Affiliates of Issuer	FINRA Rule 5121	The term "affiliate" means an entity that controls, is controlled by or is under common control with a member. "Employees," while not defined in FINRA Rule 5121, include all employees of an issuer, according to FINRA's responses to comments.

Type of Purchaser	Source of Definition	Definition
Knowledgeable Employees of Private Funds	Investment Company Act Rule 3c-5	"Knowledgeable employees" include the management of the company, such as directors, trustees, general partners, advisory board members and "executive officers"—defined as: president, vice president in charge of a principal business unit, division or function, any other officer who performs a policy-making function and any other person who performs a similar policy-making function. "Knowledgeable employees" also include those who participate in investment activities in connection with his or her regular functions or duties, has been performing such functions and duties for at least 12 months, and is not performing solely clerical, secretarial or administrative functions. The 12-month limit is not limited to 12 months at the employee's current company. "Knowledgeable employees" does not include (i) marketing and investor relations professionals who explain potential and actual portfolio investments of a fund and the investment decision-making process; (ii) attorneys who provide advice in the preparation of offering documents and the negotiation of related agreements; (iii) brokers and traders of a broker-dealer related to the fund who are series 7 registered; (iv) financial, compliance, operational and accounting officers of a fund; or (v) research analysts who investigate the potential investments for the fund unless they research all potential portfolio investments and provide recommendations to the portfolio manager.
Eligible Contract Participants	Securities Exchange Act of 1934, as amended (the "Exchange Act") Section 3(a)(65)	The definition of "eligible contract participant" refers to its definition contained in the Commodity Exchange Act (as amended by the Dodd-Frank Act) which includes: financial institutions; insurance companies; investment companies; commodity pools; business entities, such as corporations, partnerships, and trusts; employee benefit plans; government entities, such as the United States, a State or local municipality, a foreign government, a multinational or supranational government entity, or an instrumentality, agency or department of such entities; market professionals, such as broker dealers, futures commission merchants, floor brokers, and investment advisors; and natural persons with a specified dollar amount invested on a discretionary basis. For certain of the entities and market professionals, the definition also contains certain conditions relating to the amount of assets or amount of monies invested on a discretionary basis.

Appendix B – Exempt Offerings

If the private placement is limited to the following types of offerings, then it will not be subject to FINRA Rule 5123:

Type of Offering	Source of Definition	Definition
Pursuant to Rule 144A of the Securities Act or SEC Regulation S	Securities Act Rule 144A or SEC Regulation S	Regulation S provides an exclusion from the Section 5 registration requirements of the Securities Act for offerings made outside the United States by both US and foreign issuers, whether private or public. Regulation S is available for offerings of both equity and debt securities.
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	n/a	n/a

Appendix C – Exempt Securities

If the private placement is limited to the following types of securities, then it will not be subject to FINRA Rule 5123:

Type of Securities	Rule	Definition
Exempted Securities	Exchange Act Section 3(a)(12)	"Exempted securities" consist of (i) government securities; (ii) municipal securities; (iii) any interest or participation in any common trust fund or similar fund that is excluded from the definition of the term ''investment company;'' (iv) any interest or participation in a single trust fund, or a collective trust fund maintained by a bank, or any security arising out of a contract issued by an insurance company, which interest, participation, or security is issued in connection with a qualified plan; (v) any security issued by or any interest or participation in any pooled income fund, collective trust fund, collective investment fund or similar fund that is excluded from the definition of an investment company; (vi) interest or participation in any church plan, company, or account that is excluded from the definition of an investment company; and (vii) such other securities (which may include, among others, unregistered securities, the market in which is predominantly intrastate) as the Commission may, by such rules and regulations as it deems consistent with the public interest and the protection of investors.
Exempt Securities with Short-Term Maturities	Securities Act Section 3(a)(3)	"Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."
Subordinated Loans	Exchange Act Rule 15c3-1, Appendix D	Pursuant to a written subordination agreement between the broker or dealer and the lender, which (i) has a minimum term of one year, except for temporary subordination agreements, and (ii) is a valid and binding obligation enforceable in accordance with its terms (subject as to enforcement to applicable bankruptcy, insolvency, reorganization, moratorium and other similar laws) against the broker or dealer and the lender and their respective heirs, executors, administrators, successors and assigns.
"Variable Contracts"	FINRA Rule 2320 (b)(2)	The term "variable contracts" shall mean contracts providing for benefits or values which may vary according to the investment experience of any separate or segregated account or accounts maintained by an insurance company.
Modified Guaranteed Annuity Contracts and Modified Guaranteed Life Insurance Policies	FINRA Rule 5110(b)(8)(E)	"[M]odified guaranteed annuity contracts and modified guaranteed life insurance policies, which are deferred annuity contracts or life insurance policies the value of which are guaranteed if held for specified periods, and the nonforfeiture value of which are based upon a market-value adjustment formula for withdrawals made before the end of any specified period."
Non-Convertible Debt or Preferred Securities by Issuers that Meet the Eligibility Criteria For Incorporation by Reference	Rules for Forms S-3 and F-3	The eligibility criteria for issuers who wish to use incorporation by reference include (i) the registrant is already subject to the requirement to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act; (ii) the registrant has filed all reports and other materials required to be filed by Sections 13(a), 14, or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports and materials); (iii) the registrant has filed an annual report required under Section 13(a) or Section 15(d) of the Exchange Act for its most recently completed fiscal year; or (iv) the registrant is not and during the past three years neither the registrant nor any of its predecessors was: (a) a blank check company; (b) a shell company, other than a business combination related shell company; or (c) a registrant for an offering of penny stock.
Securities of a Commodity Pool Operated by a Commodity Pool Operator	Commodity Exchange Act Section 1a(11)	"Commodity pool operator" means any person (i) engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests, including any (I) commodity for future delivery, security futures product, or swap; (II) agreement, contract, or transaction described in section 2(c)(2)(C)(i) of this title or section 2(c)(2)(D)(i) of this title; (III) commodity option authorized under section 6c of this title; or (IV) leverage transaction authorized under section 23 of this title; or (ii) who is registered with the Commission as a commodity pool operator.

Type of Securities	Rule	Definition
Business Combination TransactionS	Securities Act Rule165(f); Rule 145(a)	Any transaction specified in Rule 145(a)—including reclassifications, mergers of consolidations and transfers of assets—or exchange offer.
Offerings by Registered Investment CompanieS	Investment Company Act	*See* Investment Company Act and rules thereunder.
Standardized Options	Securities Act Rule 238	Exemption for standardized options include those that are: (i) issued by a clearing agency registered under Section 17A of the Exchange Act; and (ii) traded on a national securities exchange registered pursuant to Section 6(a) of the Exchange Act or on a national securities association registered pursuant to Section 15A(a) of the Exchange Act limited by the provisions of Section 17 of the Securities Act and any offer or sale of a standardized option by or on behalf of the issuer of the securities underlying the standardized option, an affiliate of the issuer, or an underwriter.
Filed with FINRA Under Any of FINRA Rules 2310, 5110, 5121 and 5122	FINRA Rules 2310, 5110, 5121 and 5122	Rule 2310: Direct Participation Programs Rule 5110: Corporate Financing Rule–Underwriting Terms and Arrangements Rule 5121: Public Offerings of Securities With Conflicts of Interest Rule 5122: Private Placements of Securities Issued by Members

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