CLIENT UPDATE

BROKER-DEALERS MUST FILE PRIVATE FUND OFFERING DOCUMENTS IN CERTAIN ESC AND SECTION 3(C)(1) FUND OFFERINGS

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On December 3, 2012, FINRA Rule 5123 ("Rule 5123") became effective. Rule 5123 requires, subject to broad exceptions, FINRA member broker-dealers ("FINRA members") that sell securities in private placements to file with FINRA copies of private placement memoranda (each a "PPM"), term sheets and other disclosure documents used in the sales within 15 calendar days after the date of first sale.[1] This memorandum discusses the applicability of Rule 5123 to offerings of interests in private equity and hedge funds ("private funds"). While we expect that the impact of Rule 5123 on private fund offerings will be minimal, it is a further indication of FINRA's interest in enhancing private placement oversight.

SUMMARY

Virtually all U.S. broker-dealers are required to be members of FINRA. As a result, Rule 5123's filing and other requirements potentially apply to almost all U.S. placement agents hired by, and U.S. broker-dealers affiliated with, alternative asset managers and involved in placing interests in the private funds advised by those managers.

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1 Regulatory Notice 12-40 (September 2012); Notice of Filing of Amendments No. 2 and No. 3 and Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendments No. 1, No. 2, and No. 3 to Adopt FINRA Rule 5123 (Private Placements of Securities) in the Consolidated FINRA Rulebook, SEC Release No. 34-67157 (June 7, 2012).

As discussed in detail below, Rule 5123 *will not apply* to offerings of interests in private funds that are exempt from registration under the Investment Company Act of 1940 (the "Investment Company Act") by virtue of Section 3(c)(7), which exempts offerings of interests in private funds whose securities are held exclusively by "qualified purchasers." However, it appears that Rule 5123 generally *will apply* to the following narrow categories of private offerings of interests in private funds that are placed by FINRA members to the extent that such offerings are sold to persons who are not "qualified purchasers," legal entity (as opposed to individual) "accredited investors" or "knowledgeable employees" (as such terms are defined below):

- offerings of interests in "friends and family," employee and other funds that rely on Section 3(c)(1) of the Investment Company Act (*i.e.*, funds with no more than 100 security holders); and
- absent further guidance from FINRA, private offerings of interests in employees' securities companies ("ESCs").

In the case of ESCs, Rule 5123 exempts offerings sold to employees and affiliates of an issuer; however, this exemption does not explicitly extend to sales to employees of affiliates of the issuer, their family members or consultants to the employer, who are not knowledgeable employees.

Rule 5123 filings are "notice" filings for which FINRA does not expect to provide any comment. FINRA has specifically clarified that the filing requirement will not establish any sort of review or approval process by FINRA for private placements. Additionally, FINRA has stated that it will accord confidential treatment to all PPMs and other offering documents filed pursuant to Rule 5123.

In view of FINRA's heightened interest in private placements, we suggest that FINRA members, and private fund managers with affiliated broker-dealers that are FINRA members, review their policies and procedures on private placements with an eye towards ensuring proper coverage of all issues of concern to FINRA and, now that Rule 5123 has gone into effect, that written compliance and supervisory procedures covering Rule 5123 are in place and that these polices and procedures are reasonably designed to ensure that the broker-dealer will satisfy the Rule's requirements.

Background and a more detailed discussion of Rule 5123 follows.

BACKGROUND

Rule 5123 is the latest example of FINRA's heightened interest in recent years in the role of broker-dealers in private placements.

- In April 2010, FINRA issued Regulatory Notice 10-22 ("Notice 10-22"),[2] which discusses the obligations of broker-dealers in connection with private placement offerings. Notice 10-22 states that broker-dealers must, among other things, consider suitability issues with respect to the securities being offered and perform due diligence on the issuer of those securities. The notice goes on to specifically caution broker-dealers that are affiliated with the issuer to ensure that their independence is not compromised when assessing suitability and/or conducting due diligence.
- Over the past several years, FINRA has initiated multiple enforcement actions against broker-dealers and their employees for perceived failures with respect to private placements. Notice 10-22 is the roadmap for these enforcement cases. Also of note is FINRA's focus on noncompliant marketing materials provided in connection with the offerings.
- Rule 5123 was preceded by FINRA Rule 5122, adopted in 2011 ("Rule 5122"), which requires broker-dealers to file with FINRA information about private placements of the broker-dealers' own securities or the securities of their "control entities," subject to certain exceptions.[3] While Rule 5122 has had little impact on our private fund clients, it highlights FINRA's recent focus on private placements.

RULE 5123 FILING REQUIREMENT

Rule 5123 requires FINRA members that sell any security issued by a non-member in an offering conducted in reliance on an available exemption from registration under the Securities Act of 1933 (the "Securities Act") (a "private placement")[4] to:

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2 Notice 10-22 is available here: http://www.finra.org/Industry/Regulation/Notices/2010/P121299

3 Control entities generally do not include private funds that are advised by an investment adviser affiliated with the broker-dealer or for which an affiliate of the broker-dealer acts as general partner, unless the affiliated adviser or general partner entity owns more than 50% of the fund (or is entitled to receive more than 50% of the profits or losses of the entity).

4 Before its adoption, proposed Rule 5123 had been the subject of two rounds of comments and, over the course of three amendments, FINRA significantly pared down Rule 5123 from its initial proposal. Rule 5123, as adopted, among other things, no longer extends to FINRA members' "associated persons," no longer requires specified disclosure to investors about offering expenses, offering compensation and the intended use of offering proceeds, and now exempts offerings made to legal entity accredited investors and knowledgeable employees (as discussed herein). Importantly,

- file with FINRA any offering documents (including the PPM) used in connection with a sale, or any material amendment thereto, within 15 calendar days of the date of first sale or, in the case of amendments, within 15 calendar days of providing such materially amended documents to investors; or
- indicate to FINRA that no such offering documents were used.

PURCHASERS NOT COVERED BY RULE 5123

Rule 5123 does not apply to several types of private placements, including offerings sold only to any one or more of the following classes of purchasers:

- institutional accounts, as defined in Rule FINRA Rule 4512(c);[5]
- qualified purchasers as defined in Section 2(a)(51)(A) of the Investment Company Act;[6]
- qualified institutional buyers, as defined in Rule144A under the Securities Act;
- investment companies, as defined in Section 3 of the Investment Company Act;
- an entity composed exclusively of qualified institutional buyers, as defined in Securities Act Rule 144A;
- banks, as defined in Section 3(a)(2) of the Securities Act;
- employees and affiliates of the issuer;[7]
- knowledgeable employees as defined in Investment Company Act Rule 3c-5;
- eligible contract participants, as defined in Section 3(a)(65) of the Securities Exchange Act of 1934 (the "Exchange Act"); and
- accredited investors described in Securities Act Rule 501(a)(1), (2), (3) or (7).[8]

Amendment No. 1 to the originally proposed Rule clarified that offerings pursuant to Securities Act Sections 4(1), 4(3) and 4(4) (which generally exempt secondary transactions) are excluded from the Rule.

5 An "institutional account" is defined as the account of: "(*1*) a bank, savings and loan association, insurance company, or registered investment company; (*2*) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (*3*) any other person (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million."

6 Most large private funds rely on the exemption from registration under the Investment Company Act provided by Section 3(c)(7) of that Act, which limits purchasers to qualified purchasers and "knowledgeable employees."

7 For purposes of Rule 5123, an "affiliate" is any entity that controls, is controlled by, or is under common control with a member. It is our understanding that, while affiliated entities would be exempt, employees of affiliates of the issuer would not be.

FINRA has stated that these various categories of exemptions may be combined. In other words, if, for example, securities are privately offered both to qualified purchasers and knowledgeable employees, then the offering of such securities would be exempt from Rule 5123, because all of the purchasers fall into exempt categories.

CATEGORIES OF OFFERINGS NOT COVERED BY RULE 5123

In addition, Rule 5123 would exempt several broad categories of offerings. Of greatest relevance to private fund managers, the categories of exempt offerings include those:

- made pursuant to Securities Act Rule 144A or Regulation S; and
- of securities of a commodity pool operated by a commodity pool operator, as defined under Section 1a(11) of the Commodity Exchange Act.

The duty to file may vary for each individual member participating in an offering, which means that different members in the same offering may qualify for different exemptions depending on the nature of their specific sales.

Finally, any member that does not fall within an enumerated exemption may apply to FINRA for an exemption if they can show good cause.

PROCEDURAL CONSIDERATIONS AND CONFIDENTIALITY

Rule 5123's prescribed filings are intended to coincide with the Form D filing requirements and, like Form D, would be "notice" filings for which FINRA does not expect to provide any comment. In fact, FINRA has specifically clarified that the filing requirement will not establish any sort of review or approval process by FINRA for private placements. The filings must be made by each FINRA member participating in an offering and should be made within 15 days of the first sale by the particular member making the filing.

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[8] Note that Securities Act Rule 501(a)(1), (2), (3) or (7) captures accredited investors that are entities. Offerings sold to individual, natural person accredited investors are not exempt from Rule 5123, so offerings to individuals who are neither accredited investors, knowledgeable employees or employees of the issuer are not exempt from Rule 5123.

FINRA will accord confidential treatment to all documents and information filed pursuant to Rule 5123. FINRA has stated that it plans to utilize such documents and information solely for the purpose of review to determine compliance with the provisions of applicable FINRA rules or for other regulatory purposes deemed appropriate by FINRA.

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Please do not hesitate to contact us with any questions concerning Rule 5123.

December 5, 2012