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New FINRA Regulatory Notice Addresses Broker-Dealer Obligations in Regulation D Offerings

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FINRA Issues Regulatory Notice 10-22, April 20, 2010 - The Obligations and Conduct of Broker-Dealers In Regulation D Offerings

On April 20, 2010, The Financial Industry Regulatory Authority, known as FINRA, issued Regulatory Notice 10-22 setting forth guidance for its member firms concerning their obligations and requirements for selling securities in private placements, including PIPEs, under Regulation D of the Securities Act of 1933. In this notice, FINRA reminded broker-dealers of their duty – enforceable under the federal securities laws and FINRA rules – to conduct a reasonable investigation of an issuer and the securities that it recommends in private placements, including those sold in Reg D offerings.[1] Although Reg D provides an exemption from the registration requirements under Section 5 of the Securities Act, it should be noted that Reg D offerings are not exempt from the antifraud provisions of applicable federal securities laws. In addition, broker-dealers that recommend an issuer's securities in a Reg D offering must also satisfy the "suitability requirements" under NASD Rule 2310, and must comply with the advertising and supervisory rules of FINRA and the United States Securities and Exchange Commission.

While the private placement market is an important source of capital for many United States public companies, FINRA has identified considerable problems in several recent investigations of certain Reg D offerings. In its press release concerning Regulatory Notice 10-22,[2] FINRA quoted its CEO, Rick Ketchum: "An increase in investor complaints regarding private placements, as well as SEC actions halting sales of certain private placement offerings, led FINRA to launch a nationwide initiative that involves active examinations and investigations of broker-dealers engaged in retail sales of private placement interests....That initiative has uncovered misconduct, including fraud and sales practice abuses. While several enforcement actions have been taken and additional investigations are underway, FINRA is taking this opportunity to remind firms of their substantial duties when engaging in the sale of private placement offerings."

Federal Antifraud Securities Laws Apply to Reg D Offerings

Under the Securities Act, any offer to sell securities must either be registered with the SEC or qualify for an exemption from registration. Reg D provides a safe harbor exemption from the registration requirements of Section 5 of the Securities Act for certain private offerings.

Although liability under Section 11 of the Securities Act does not attach to a Reg D offering because it does not involve a registration statement, the SEC and federal courts have long held that such offerings are not exempt from the antifraud provisions of the federal securities laws.[3] Broker-dealers, like other securities market participants, must comply with such provisions. Broker-dealers recommending securities in Reg D offerings must also comply with many requirements that are designed to maintain high industry standards, including adherence to FINRA Rule 2010, which requires just and equitable principles of trade, and FINRA Rule 2020, which prohibits manipulative and fraudulent devices.

The antifraud provisions prohibit misstatements and misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities, including in Reg D offerings, and the SEC has enforced these provisions where it considers a broker-dealer’s activities to be manipulative, deceptive, fraudulent or otherwise unlawful.

Accordingly, broker-dealers must conduct their Reg D offering activities in a manner that avoids manipulative and fraudulent practices. To this end, a broker-dealer involved in a Reg D offering has a *duty* to conduct a reasonable investigation concerning the securities being offered and of the issuer's representations about them. The duty to conduct a reasonable investigation springs from the broker-dealer's relationship to the investor, and from the fact that in recommending such security, the broker-dealer represents to the investor "that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation."[4] Failure to comply with this duty can constitute a violation of the antifraud provisions of the federal securities laws.

What Level of Investigation Is Sufficient?

The level and type of investigation required by a broker-dealer depends upon the particular facts and circumstances, and must be determined on a case-by-case basis. Factors in this regard include, but are not limited to, the nature of the offering recommendation, the role of the broker-dealer in the offering, its knowledge of the issuer, the level of sophistication of the investor (e.g., institutional, accredited or retail), and its knowledge of and relationship to the issuer, as well as the relative stability of the issuer. As a general rule, based upon federal case law, a more comprehensive investigation is necessary for private companies and companies with smaller market capitalizations, especially if such issuer has not been public for an extended period of time.

It should be noted that there are no clear-cut rules setting forth what a broker-dealer should do to fulfill its responsibilities in this regard, and each broker-dealer must make a determination of the scope of its investigation based upon the facts and circumstances. In light of FINRA's guidance, we have set forth below a few "rules of thumb" that broker-dealers should consider in this regard:

Broker-dealers should conduct their own reasonable investigation of the issuer and the security offered, and should not blindly rely on the statements and information provided by an issuer or its counsel.[5] For example, broker-dealers should review an issuer's financial statements and trends, inquire about pending material litigation matters, inquire about the material intellectual property matters relevant to such issuer, speak with the issuer's auditor and audit committee chairperson, probe into the issuer's business prospects, if appropriate, speak with the issuer's significant customers or suppliers, as the case may be, try to verify the issuer's verbal and/or written statements and representations that are material to a particular issuer, including those regarding the business prospects of the issuer, the assets held or to be acquired, the claims and other material statements made by management and the intended use of proceeds of an offering;

- With respect to reporting companies under the Securities Exchange Act of 1934, in the absence of investigatory red flags, a broker-dealer that is not an underwriter typically may rely upon the current registration statement and periodic reports of the public company;

- Equally important is disclosure by the broker-dealer to an investor that it does not have certain material information concerning an issuer or its securities at the time it recommends the sale of such issuer's securities in a Reg D offering;

- Should any negative or potentially negative issues arise during an examination of an issuer or its securities, the broker-dealer should further investigate as to such issues;

- A broker-dealer that is an affiliate of an issuer in a Reg D offering must ensure that its affiliation does not compromise its independence as it performs its investigation. The broker-dealer must also resolve any conflict of interest that may prejudice the investigation or impede its ability to conduct a thorough and independent investigation;

Disclose the risk factors related to the absence of such material information, if any;

- The fact that an investor is sophisticated and knowledgeable does not eliminate the broker-dealer's obligation to conduct a reasonable investigation in a Reg D offering;

- The broker-dealer must conduct a reasonable investigation in connection with *each* offering of an issuer, notwithstanding that a subsequent offering may be for the same issuer;

- While issuers are not required to provide "accredited investors" with a private placement memorandum in order to qualify for the exemptions in Rule 505 or Rule 506 of Reg D, these memoranda typically are used in Reg D offerings and broker-dealers may need to consider whether the absence of a private placement memorandum itself might constitute a red flag;

- The refusal by an issuer to provide information that is essential to the broker-dealer's duty to conduct a reasonable investigation may itself constitute a red flag. That is, if an issuer is not forthcoming with information requested by a broker-dealer (or provides information that is non-responsive or out-of-date), the broker-dealer must determine whether sufficient information is otherwise obtainable;

- NASD Rule 3010 requires that broker-dealer firms participating in Reg D offerings must have supervisory procedures that are reasonably designed to ensure that such broker-dealer's personnel, including its registered representatives, conduct an investigation that is sufficiently thorough in order to comply with the legal and regulatory requirements set forth and discussed in this client alert; and

- FINRA set forth on pages 8-10 of Regulatory Notice 10-22 a checklist of practices that some broker-dealers have utilized to satisfactorily fulfill their reasonable investigation obligations.

A broker-dealer is not prohibited from retaining outside counsel or other experts to assist it in satisfying its reasonable investigation obligation. It should also be noted, however, that the retention and utilization of counsel or experts by the broker-dealer does not necessarily satisfy its responsibilities in this regard. For example, such external counsel's or expert's findings may raise issues or concerns that require further investigation by the broker-dealer, whose responsibility it then becomes to complete its inquiry.

If a broker-dealer is a member of a larger selling syndicate, such broker-dealer is permitted in a Reg D offering to rely upon a reasonable investigation by the syndicate manager (or lead placement agent), provided the broker-dealer has reason to believe that the syndicate manager has the expertise and absence of conflicts to engage in a thorough and independent inquiry, and that it has in fact performed and completed such an inquiry with respect to the particular Reg D offering, including satisfaction of the suitability requirement discussed below. The implication here is that if a broker-dealer believes that the syndicate manager has not addressed a particular issue, then each syndicate broker-dealer participating in the offering will be responsible to the extent that it affects such broker-dealer's own suitability analysis.

Finally, it is important for a broker-dealer to *document its investigation* in the event that it is called upon to demonstrate compliance. To that end, the broker-dealer should retain records documenting both the process and results of its investigation, including, notes, dates and descriptions of any investigatory meetings held and other tasks performed, maintain a list of the documents and other information reviewed, as well as the individuals who attended the meetings or conducted the document examination or meeting inquiry.

Suitability Requirements

A broker-dealer has an obligation to recommend to investors only those specific investments or overall investment strategies that are suitable to such investors in accordance with their investment objectives. This obligation is referred to as the Suitability Requirement. The concept of suitability appears in NASD Rule 2310 and has been interpreted as an obligation under the antifraud provisions of the federal securities laws.

There are two prongs to the suitability requirement: (i) a broker-dealer must have an "adequate and reasonable basis" for any recommendation of a security or strategy that it makes – “reasonable basis suitability”; and (ii) a broker-dealer has a duty to determine “customer specific suitability.”

“Reasonable basis suitability” relates to the specific security or strategy recommended by a broker-dealer. The broker-dealer, therefore, has an obligation to investigate and obtain sufficient information about the security it is recommending.

“Customer specific suitability” requires that the broker-dealer determine whether the recommended security is suitable for the particular investor based upon the investor's financial situation, needs and other security holdings. This requirement has been construed to impose a duty of inquiry on broker-dealers to obtain relevant investor information relating to their financial situations and to keep such information current. FINRA considers recommendations to be unsuitable when they are inconsistent with the investor's investment objectives.

One important caveat to the “customer suitability” requirement is that, under NASD Rule 2310(b) and NASD IM-2310-3, a broker-dealer that recommends a securities transaction to an “institutional investor” will be deemed to have discharged its suitability obligation under Rule 2310 if the institutional investor is making an independent decision regarding the risks associated with the investment and is capable of evaluating such risk.

FINRA is Focused on Enforcing the Obligations of Member Broker-Dealers

It is clear that FINRA is putting renewed emphasis on enforcing the rules governing broker-dealer activities in Reg D offerings. In fact, FINRA has brought three enforcement actions in recent months involving private placement offering violations, which include a complaint charging McGinn, Smith & Co. of Albany and its president with securities fraud in the sales of tens of millions of dollars of unregistered securities; the expulsion of Dallas-based Provident Asset Management for marketing a series of fraudulent private placements offered by an affiliate in a massive Ponzi scheme; and fines totaling $750,000 against Pacific Cornerstone Capital, Inc. of Irvine, CA, and its former CEO for failing to include complete information in private placement offering documents and marketing material, as well as for advertising violations and supervisory failures.

Broker-dealers participating in Reg D offerings are advised to revisit their compliance policies surrounding Reg D offerings, and to discuss any related issues with appropriate personnel and/or counsel in order to avoid running afoul of FINRA and SEC rules concerning broker-dealer responsibilities in Reg D offerings.

1 See Executive Summary at: http://www.finra.org/Industry/Regulation/Notices/2010/P121299.

2 See FINRA press release, dated April 20, 2010: http://www.finra.org/Newsroom/NewsReleases/2010/P121305.

3 Securities and Exchange Act of 1934, Section 9(a) prohibits particular manipulative practices regarding securities registered on a national securities exchange. Section 17(a) of the Securities Act makes it unlawful for any person in the offer or sale of any securities or any security-based swap agreement in interstate commerce or by use of the mails, directly or indirectly. Section 10(b) is a broad "catch-all" provision that prohibits the use of "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of any security. Section 15(c)(1) prohibits broker-dealers from effecting transactions in, or inducing the purchase or sale of, any security by means of "any manipulative, deceptive or other fraudulent device," and Section 15(c)(2) prohibits a broker-dealer from making fictitious quotes.

4*Hanly v. SEC*, 415 F.2d 589, at 597 (2d cir. 1969).

5 In *SEC v. Kunz and Cline Investment Management, Inc.*,Admin. Proc. File No. 3-9960, aff'd 2003 U.S. App. LEXIS 6011 (10th Cir. 2003), the SEC found that the broker could not justifiably rely on financial statements in private placement memoranda that had been audited and certified by an accountant when numerous "red flags" indicated that the financial statements were inaccurate. The broker had a duty, which it failed to discharge, to conduct a further, independent investigation of the financial condition of the issuer under the circumstances. The SEC also found that the broker acted contrary to just and equitable principles of trade when the private placement memorandum failed to disclose both the broker's consulting relationship with the issuer and the litigation history of the issuer's president and CEO.