FINRA Issues Regulatory Notice Reminding Broker-Dealers of Obligations to Conduct Reasonable Investigations in Regulation D Offerings

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In April 2010, the Financial Industry Regulatory Authority ("FINRA") issued a Regulatory Notice (the "Notice") to remind broker-dealers ("BDs") of their obligation, enforceable under federal securities laws and under FINRA rules, to conduct reasonable investigations of the issuer and the issuer's securities the BD recommends in private placement offerings made under Regulation D under the Securities Act of 1933 (the "Securities Act").[1] Moreover, any BD that recommends securities offered under Regulation D must conduct FINRA's required customer suitability analysis and must also comply with advertising and supervisory rules under FINRA and the SEC.

The Notice reflects FINRA's concerns with fraud and abuses by BDs that it has found in connection with several recent Regulation D offerings, such as BDs' provision to prospective investors of private placement memoranda and other sales materials that contained inaccurate statements or omitted information necessary to make informed investment decisions. The full text of the Notice is available on the FINRA website at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf.

Although the FINRA Notice applies to BD compliance requirements in connection with private placements, the Notice is also relevant to issuers who are contemplating or conducting private placement offerings, whether brokered or not. Issuers as well as BDs are subject to anti-fraud provisions under U.S. securities laws in connection with securities offering disclosures, and in the case of brokered offerings, issuers need to be cognizant of the BD's obligation to conduct a reasonable investigation concerning the offered security and the issuer's representations about the offered security. BDs would need to review, at a minimum, information concerning the issuer's business, forecasts, financial statements and other matters as the BD determines necessary to comply with its investigation requirements. The BD investigation requirements apply particularly to smaller, newer issuers that are not reporting companies under the Securities Exchange Act of 1934 (the "Exchange Act"), which could include many Regulation D issuers.

The Notice briefly summarizes the elements of the Regulation D private placement exemption from Securities Act registration requirements, and discusses BDs' obligations to conduct reasonable investigations and customer suitability analyses in connection with private placement offerings. The Notice also highlights specific issues that pertain to a BD's responsibilities in conducting its investigation, and provides information about practices that some BDs have adopted to help them discharge their reasonable investigation obligations, particularly setting forth suggestions concerning categories of issuer information that should be reviewed in the course of the BD's investigation.

REGULATION D

Regulation D is a private placement exemption comprising a group of rules that govern the limited offer and sale of securities pursuant to exemptions from registration requirements under the Securities Act. Each of the three individual Regulation D exemptive rules requires that the offering under the respective rule meet specified requirements including limitations on offering size and on the number of investors in the offering and, in some cases, the provision of specified information to prospective investors. Under 2 of the 3 Regulation D rules (Rules 505 and 506), the issuer may sell to an unlimited number of accredited investors and up to 35 non-accredited investors. As currently defined in Rule 501 under Regulation D, an "accredited investor" means any person who meets, or who the issuer reasonably believes meets, certain requirements, including natural persons with a net worth in excess of $1,000,000, or annual income of $200,000 (or $300,000 jointly with a spouse). Rules 505 and 506 do not require that an issuer provide any specific written information to accredited investors, although issuers must, prior to sales to non-accredited investors in the offering, provide specified, comprehensive, information to these investors.[2] In practice, issuers often provide a private placement memorandum that describes the offering to all prospective purchasers, including accredited investors.

BD REGULATORY REQUIREMENTS IN REGULATION D OFFERINGS

<u>Duty to Conduct Reasonable Investigation of Securities It Recommends</u>. Although Regulation D offerings are exempt from registration requirements under the Securities Act, these offerings are not exempt from the anti-fraud provisions of the federal securities laws. A BD has a duty, enforceable under federal securities laws and FINRA rules, to conduct a reasonable investigation of securities that it recommends, including those sold in a Regulation D offering. As set forth in the Notice:

[1] Securities offered in Regulation D private placements are exempt from Securities and Exchange Commission (the "SEC") registration requirements and therefore any offering materials for these private placements would not be subject to review by the SEC.

[2] The required information is essentially the same for issuers whether or not they are reporting companies under the Exchange Act. It includes financial statements, description of business, management's discussion and analysis of financial condition and results of operations, executive compensation, corporate governance, risk factors and use of proceeds of the offering. If the issuer is a reporting company under the Exchange Act, the information would be obtained from its SEC filings.

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- The SEC and federal courts have long held that a BD that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer's representations about the offered security.
- In recommending the security, the BD represents to the customer that a reasonable investigation has been made and that the BD's recommendation rests on the conclusions based on such investigation.
- Failure to comply with this duty can constitute a violation of the anti-fraud provisions of the federal securities laws including Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and can also constitute a violation of FINRA Rule 2010, which requires adherence to just and equitable principles of trade, and FINRA Rule 2020, which prohibits manipulative and fraudulent devices.

Scope of Investigation; Reliance on Issuer-Supplied Information. Each BD must make a determination of the scope of its investigation based on facts and circumstances. Courts have found that the amount and nature of the investigation required depends, among other factors, upon the nature of the recommendation, the BD's role in the transaction, its knowledge of and relationship to the issuer, the size and stability of the issuer and whether the issuer is a reporting company under the Exchange Act. A more thorough investigation is required for securities issued by smaller companies of recent origin, which could include many Regulation D issuers. The fact that a BD's customers may be sophisticated and knowledgeable does not obviate the duty to investigate.

If a BD relies on information supplied by the issuer as a basis for its recommendation, it is possible that the BD may be found to have conducted a reasonable investigation for this purpose, depending on the facts and circumstances underlying the BD's reliance. In general, however, a BD may not rely solely upon the issuer for information concerning that issuer without making its own investigation, nor may it rely on the information provided by the issuer and its counsel in lieu of conducting its own reasonable investigation and independently verifying an issuer's representations and claims, which must be done with a high degree of care.[3] This is particularly important when an issuer seeks to finance a new speculative venture, since special care is typically required to verify the issuer's often self-serving statements.

In the course of a reasonable investigation, a BD must note and follow up on any information that it encounters that could be considered a "red flag" that would alert a prudent person to conduct further inquiry, and must also investigate any substantial adverse information about the issuer. When a BD encounters a red flag, such as indications of financial statement inaccuracy, the BD must do more than simply rely upon representations by issuer's management, disclosure in an offering document or even a due diligence report of issuer's counsel, but rather must conduct a further, independent investigation of the financial condition of the issuer under the circumstances. In addition, if a BD lacks essential information about an issuer or its securities when it makes a recommendation, including recommendations of securities in Regulation D offerings, it must disclose this fact as well as the risks that arise from its lack of information.[4] An issuer's refusal to provide a BD with information that is necessary for the BD to meet its duty to investigate could itself constitute a red flag.

FINRA Customer Suitability Obligations. NASD Rule 2310 requires that a BD firm have reasonable grounds to believe that a recommendation to purchase, sell or exchange a security is suitable for the customer. The "suitability" analysis has two principal components: knowledge of the product, and knowledge of the customer. Knowledge of the product requires that the BD firm have a reasonable basis to believe, based on a reasonable investigation, that the recommendation is suitable for at least some investors. Therefore, the BD needs to conduct a reasonable level of due diligence regarding the issuer and the information provided in the placement memorandum and other offering documents. The second part of the "suitability" analysis requires the BD to determine whether the proposed investment is suitable for the particular investor to whom it would be recommended. FINRA has emphasized that "the fact that an investor meets the net worth or income test for being an accredited investor is only one factor to be considered in the course of a complete suitability analysis".[5]

SPECIFIC ISSUES RELATED TO A BD'S INVESTIGATION RESPONSIBILITIES

Required Scope of Investigation; Increased Scope Required to the Extent of BD Involvement with Issuer and BD's Preparation of Disclosure Document. The scope of the BD's investigation will necessarily depend on a number of factors, including the nature of the investors (i.e., whether they are retail customers or more sophisticated institutional investors) and the BD. The scope of the BD's investigation would necessarily increase to the extent that the BD is affiliated with the issuer or prepares, or assists in the preparation of, the private placement offering memorandum. A BD that is an affiliate of an issuer in a Regulation D offering must ensure that its affiliation does not compromise its independence as it performs its investigation. As to the private placement memorandum, FINRA has taken the position that a BD firm which prepares a private placement memorandum containing material misstatements or omissions violates FINRA Rule 2010, which requires BD firms to comply with just and equitable principles

[3] If the BD retains counsel or other experts to assist the BD in fulfilling its investigation obligations, the BD must review the qualifications of such persons, and must separately investigate any issues or concerns identified by them in the course of their investigation.

[4] With respect to a reporting company under the Exchange Act, in the absence of red flags, a BD that is not an underwriter typically may rely upon the current registration statement and periodic reports of the public company.

[5] In conducting the customer suitability analysis, the BD must also make reasonable efforts to obtain and analyze information about, among other things, the customer's other holdings, its investment objectives and its tax status. The BD must also be satisfied that the customer fully understands the risks involved in the investment and is able to take those risks. In addition, a BD in a Regulation D offering should conduct a reasonable investigation including matters such as the issuer and its management, business prospects and assets, the claims being made by the issuer and the use of proceeds of the offering.

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of trade.[6] In addition, FINRA stated in the Notice that sales literature concerning a private placement that a BD distributes, whether or not the BD assisted in its preparation, will generally be deemed to constitute a communication by that BD with the public within NASD Rule 2210, FINRA's advertising rule. If a private placement memorandum or other offering document presents information that is not fair and balanced or that is misleading, then the BD that assisted in its preparation may be deemed to have violated this advertising rule.

Reliance on Investigation by Syndicate Manager. If the BD is part of a syndicate or selling group, it is common for the BD to rely upon the lead placement agent or syndicate manager for undertaking due diligence. While FINRA recognizes this practice, it also warns BD firms that they must have a reasonable basis to believe that the syndicate manager has the expertise and absence of conflicts to undertake the inquiry and must ascertain that the syndicate manager has actually performed the investigation.

Supervisory Requirements. A BD firm that engages in Regulation D offerings must have supervisory procedures under NASD Rule 3010 that are reasonably designed to ensure that the firm's personnel, including its registered representatives, comply with its obligations in the context of private placement offerings. These obligations include, among others, engaging in an inquiry sufficient to meet legal and regulatory requirements, qualifying their customers as eligible to purchase the securities offered in the private placement, and not violating anti-fraud provisions of federal securities laws or FINRA rules in connection with preparation or distribution of offering documents or sales literature.

Documentation of Reasonable Investigation. FINRA states in the Notice that a BD should maintain records to demonstrate that it has performed a reasonable investigation. Such records should document both the process and results of the investigation, including descriptions of meetings with the issuer and others, and documentation and other information reviewed, including names of the individuals who attended the meetings or reviewed the documentation.

PRACTICES ADOPTED BY BDS TO FACILITATE COMPLIANCE WITH DUE DILIGENCE OBLIGATIONS; SUGGESTED ITEMS FOR REVIEW

The Notice sets forth a list of practices that some firms have adopted to help them adequately discharge their investigation responsibilities. The list is not necessarily comprehensive, nor is it intended to be mandatory for every offering. Rather, the items to be reviewed should be determined based on the nature of the issuer and type of offering being made. Many of the practices listed in the Notice are designed to satisfy the BD's regulatory requirements. These practices are especially relevant to Regulation D offerings of securities of companies that are non-reporting under the Exchange Act, but BDs as well as issuers are advised to review the list included in the Notice to obtain an idea of the nature and scope of the information that BDs may require to conduct their investigation. A more complete list of FINRA's suggested items for review is included in the Notice. Highlights are set forth below:

- Management of the issuer, including their background and compensation;
- The business of the issuer and its current and future obligations;
- Business plans or forecasts, and assumptions on which these are based;
- The terms of the securities being offered;
- The issuer's governing documents such as certificate of incorporation and by-laws;
- The financial condition and capital structure of the issuer;
- Quality of assets and facilities of the issuer, as applicable;
- Material contracts, relationships and affiliations of the issuer;
- The intended use of proceeds from the offering; and
- If the issuer is a reporting company under the Exchange Act, a review of the issuer's most recent public filings.

This Securities Update was written by Susan K. Shapiro, a Partner in Burns & Levinson's Securities Law Group.

Explanatory Notes:

This update is intended to provide a general summary and to call your attention to a number of rule changes which may be of possible interest and relevance to you. It is not intended to constitute a legal opinion or definitive summary of all changes that could be material to you or to serve as a substitute for legal advice.

Please contact a member of the Securities Law Group at Burns & Levinson if you have any questions about these rule changes or want to learn more about our expertise in this area.

[6] A BD that prepares the private placement memorandum or other offering document has a duty to investigate the offered securities and the issuer's representations made in the private placement memorandum or other document.

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About Burns & Levinson’s Securities Law Group

Burns & Levinson's attorneys have extensive experience representing public and private issuers, stockholder groups and individual investors. Our attorney team counsels clients on IPOs and follow-on offerings of equity, debt and other securities (including shelf registration takedowns), corporate acquisitions involving registered and restricted stock, mergers and acquisitions where one or both parties are publicly traded, private investment in public equity (PIPE) transactions, private placements, venture capital financings, and complex securities law transactions and issues, including corporate governance/ Sarbanes-Oxley and SEC and stock exchange reporting and compliance.

In the securities compliance area, we advise our clients on corporate governance/Sarbanes-Oxley and SEC and stock exchange reporting and compliance. Specifically, we assist our clients in fulfilling their ongoing SEC and stock exchange reporting obligations, managing sensitive disclosure issues internally and with industry analysts, preparing proxy statements and handling stockholder meetings, structuring employee benefit plans and executive compensation packages under the SEC's "short-swing profit" reporting and liability rules, effecting re-sales of securities in the public trading markets under the SEC's Rule 144, and advising boards of directors and board committees concerning the requirements and restrictions imposed on their actions by the securities laws and corporate governance laws such as Sarbanes-Oxley. We have served as special securities counsel to the Boards and Audit Committees of publicly traded companies looking for opinions or advice of counsel other than their regular outside counsel.

We have counseled clients both domestic and international, from emerging growth companies to large public companies, and are positioned to provide clients with timely, expert, efficient and cost effective advice that they need to meet their business objectives. We take a practical and proactive approach to the rapidly changing securities disclosure and corporate governance laws, providing our clients with timely updates, identifying specific situations in which the new laws will impact particular clients either operationally or structurally, and working with clients to implement the changes that are either required or advisable to comply with the new regulatory schemes and investor sentiment.

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