

“What keeps you up at night?”

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FINRA reminds broker-dealers of obligations in Regulation D offerings

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SUMMARY

FINRA recently issued Regulatory Notice 10-22 (Regulation D Offerings) to remind broker-dealers of their obligation to conduct a reasonable investigation of the issuer and the securities they recommend in Regulation D offerings, also known as private placements.

In the notice, broker-dealers are reminded that although the offering is exempt from the registration requirements of Section 5 under the Securities Act of 1933, the antifraud provisions of the federal securities laws still apply to the offering of such securities. Moreover, recommendations of securities offered under Regulation D must meet the suitability requirements of NASD Rule 2310 (Recommendations to Customers - Suitability) and comply with NASD Rules 2210 (Communications with Customers and the Public) and 3010 (Supervision). Whether you are a registered broker-dealer acting as a placement agent in a Regulation D offering, or an issuer planning to engage a broker-dealer, attention should be paid to FINRA's reminder.

Recent examinations by FINRA detected problems with Regulation D offerings including fraud and sales practice abuses. Specifically, broker-dealers have been sanctioned for providing private placement memoranda and sales materials to investors that contained inaccurate statements or omitted information necessary to make an informed investment decision. A broker-dealer is under a duty to conduct a reasonable investigation concerning a security and the issuer's representations about it. Failure to comply with this duty can constitute a violation of the antifraud provisions of the federal securities laws, particularly Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder and FINRA rules 2010 (Standards of Commercial Honor and Principles of Trade) and 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices).

The scope of a broker-dealer's responsibility to conduct a reasonable investigation will depend upon several factors including its affiliation with the issuer, its role in the transaction, including its role as a manager or member of the syndicate, and whether there are retail investors or more

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sophisticated institutional investors, although the duty to investigate is not obviated by dealing with sophisticated and knowledgeable customers. Other factors may include the nature of the broker-dealer's recommendation and the size and stability of the issuer. Moreover, a broker-dealer that is affiliated with the issuer must be keenly aware to avoid conflicts arising from its lack of independence and the increased expectation by some investors that the affiliation provides some specific insight into the issuer.

In addition to the factors noted above, broker-dealers also must exercise a “high degree of care” in investigating and independently verifying an issuer's representations and claims. A broker-dealer that lacks essential information about an issuer or its securities when it makes a recommendation must disclose this fact as well as the risks that arise from its lack of information. Before making a recommendation, a broker-dealer must make a determination that it has a “reasonable basis” to believe, based on reasonable investigation, that the recommendation is suitable for at least some investors and that the security is suitable for each customer to whom it is recommended.

In making a suitability determination, a broker-dealer should conduct a reasonable investigation into the issuer and its management including, but not limited to, the business prospects of the issuer, the assets held by or to be acquired by the issuer, the claims being made by the issuer and the intended use of offering proceeds. Moreover, a broker-dealer should be mindful to retain all records documenting both the process and the results of its investigation including, but not limited to, descriptions of meetings and the individuals who attended, investigatory tasks performed, documents reviewed and the results of such reviews. If a broker-dealer detects red flags – a condition that alerts a prudent person to conduct further inquiry - during its investigation, it has a duty to further investigate the condition as well as any adverse information about the issuer. One such red flag is the issuer's refusal to provide information necessary for the broker-dealer to complete its inquiry.

A broker-dealer may retain counsel to assist its investigation of the issuer. Although the use of counsel does not complete the broker-dealer's investigation responsibilities, it generally will assist the broker-dealer in indentifying additional issues and areas of concern requiring further investigation by the broker-dealer. An issuer preparing for an offering may also benefit from retaining counsel. First, counsel can advise an issuer as to how the offering process works and prepare the issuer so that the process goes smoothly and quickly. Second, counsel can advise the issuer as it chooses a broker-dealer to serve as its placement agent.

The complete text of FINRA Regulatory Notice 10-22 describing the renewed guidance can be accessed at <http://www.finra.org/Industry/Regulation/Notices/2010/P121299>.

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