

Obligations of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings

The Financial Industry Regulatory Authority ("FINRA") recently published a regulatory *Notice* reminding broker-dealers ("BD") of their obligation to conduct a reasonable investigation of both the issuer and the securities that they recommend in offerings made under the Securities and Exchange Commission's ("SEC") Regulation D. Although Regulation D provides exemptions from the registration requirements issued under Section 5 of the Securities Act of 1933, it does not exempt issuers from the antifraud provisions of the federal securities laws. A BD has an enforceable duty under federal and certain state securities laws and regulations as well as FINRA rules to conduct a reasonable investigation of securities that it recommends—including those made through Regulation D offerings.

A. What is a reasonable investigation?

While there is no uniform checklist a BD may mechanically follow to ensure compliance, FINRA has highlighted three areas that must be considered, at a minimum, in making a reasonable investigation. These areas include: (1) the issuer and its management; (2) the issuer's business prospects; and (3) the issuer's assets. Below is a list of practical suggestions with respect to each such area.

- Issuer and Its Management. The investigation of the issuer and its management should include: (a) examining the issuer's governing documents; (b) examining the historical financial statements of the issuer and its affiliates; (c) inquiring about the internal audit controls of the issuer; (d) contacting customers and suppliers regarding their interactions with the issuer; (e) reviewing the issuer's contracts, leases, financing arrangements and obligations; and (f) making reasonable inquiries concerning the issuer's management.
- Issuer's Business Prospects. The investigation of the issuer's business prospects should include: (a) inquiring about the intellectual property rights held by the issuer; (b) general study of the issuer's industry; (c) requesting a business plan, model or other description of the business intentions of the issuer and its management; and (d) requesting financial models created to generate projections on targeted returns.
- Issuer's Assets. The BD should conduct an investigation of the issuer's assets with such investigation including a visit to and inspection of a sample of the issuer's assets and facilities to determine the adequacy of the value of the assets as reflected in the financial statements.

B. How much investigation is required?

The Courts have held that the amount and nature of the requisite investigation by a BD depends on different factors of the offering, in particular the nature of the recommendation, the role of the BD in the transaction, the BD's knowledge of and relationship to the issuer and the size and stability of the issuer. For example, the SEC and the Courts recognize that a more detailed investigation would be required for securities issued by smaller, less experienced companies.

C. May the BD rely on the issuer for information?

A BD may not rely blindly on the issuer for information about the company nor may it rely

on the information provided by the issuer in lieu of conducting its own reasonable investigation. While BDs are not expected to have the same knowledge as the issuer, they are required to investigate and independently verify the issuer's representations.

D. Documentation of Reasonable Investigation

To demonstrate that it has actually performed a reasonable investigation, a BD should retain records documenting the process and the results of the investigation. For example, records should include descriptions of meetings conducted, tasks performed and documents reviewed.

E. Regulation D Offerings and FINRA Suitability Obligations

A BD is required by the National Association of Securities Dealers ("NASD") Rule 2310 to have reasonable grounds to believe that a recommendation to purchase or sell a security is suitable for the customer. This suitability analysis has two parts. First, it requires the BD to have a reasonable basis to believe, upon reasonable investigation, that the recommendation is generally suitable for at least some investors. Second, the BD must determine whether the security is particularly suitable for the customer to whom it would be recommended.

F. Supervision

A BD that participates in Regulation D offerings must have supervisory procedures to comply with NASD Rule 3010 that are designed to ensure that the firm engages in a reasonable investigation, performs the analysis required by NASD Rule 2310, qualifies their customers as eligible to purchase securities that are offered under Regulation D and does not violate the antifraud provisions of the federal securities laws.

G. Specific Examples of BD Responsibilities

The *Notice* addressed several specific examples relating to a BD's investigation requirement. These examples are as follows:

- BD that is Affiliated with the Issuer. A BD that is an affiliate of an issuer must ensure that its affiliation does not compromise its independence as it performs its investigation.
- BD that Prepares the Private Placement Memorandum. A BD that prepares either the private placement memorandum or an offering document has a duty to investigate securities offered under Regulation D and representations made in the offering document.
- Presence of Red Flags. In the course of a reasonable investigation, a BD must note any information that it encounters that it would consider a "red flag," or something that would alert a prudent person to further inquiry.
- Reliance on Counsel. A BD may retain counsel or other experts to assist the firm in undertaking its reasonable investigation obligation. The use of counsel or experts does not necessarily complete the BD's investigation responsibilities, as counsel may identify concerns that require further investigation by the BD.

If you have any questions relating to this alert, please feel free to contact any member of the [Securities Practice Group](#) at Miller & Martin PLLC.

The opinions expressed in this bulletin are intended for general guidance only. They are not intended as recommendations for specific situations. As always, readers should consult a qualified attorney for specific legal guidance. Should you need assistance from a Miller & Martin attorney, please call 1-800-275-7303.

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