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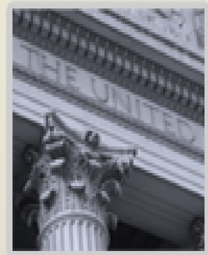

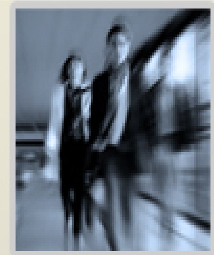

PRIVATE PLACEMENT DUE DILIGENCE AND FINRA ANTI-FRAUD ENFORCEMENT

The Financial Industry Regulatory Authority (FINRA) has recently noted significant market abuses in the sale of private placements by member firms. These abuses include fraud and sales practices directly related to the marketing of Regulation D offerings, including the delivery of private placement memoranda and sales materials to investors that contained inaccurate statements or omitted information necessary to make informed investment decisions. To address this situation, FINRA issued a reminder to membership of its current obligations with respect to the private placement of Regulation D offerings: (Regulatory Alert 10-22, Obligations of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings (the “Release”). The majority of the Release restated due diligence obligations that date back to the 1980’s when Prudential Securities incurred substantial sanctions related to the offering and sale of proprietary real estate partnerships. However, there was an interesting discussion of FINRA’s position on the anti-fraud implications to a broker-dealer with respect to due diligence.

FINRA states in the Release that as a result of a broker-dealers’ special relationship with a customer, when a broker-dealer recommends a security, they are under a duty to conduct a reasonable investigation concerning that security and the issuer’s representations about it. As a result, when the broker-dealer makes a recommendation to a customer, the broker-dealer has engaged in a reasonable investigation and its recommendation is based upon the conclusions resulting from such investigation. FINRA stated that failure to comply with this duty is a violation of the antifraud provisions of the federal securities laws and, particularly, Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 there under by the SEC. In keeping with the utilization of all tools at their command, FINRA also made it clear that such activities could also constitute a violation of FINRA Rule 2010, which requires adherence to just and equitable principles of trade, and FINRA Rule 2020, prohibiting manipulative and fraudulent devices.

The utilization of this theory by FINRA is problematic in that it appears that FINRA intends to hold brokers responsible for an unaffiliated issuer's false statements, based in part on a lack of due diligence documentation. No one advocates fraud, and it is clear that adequate and through due diligence initiatives are imperative. However, the implication that a due diligence oversight can lead to a violation of the antifraud provisions of the federal securities laws, particularly, Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 is significant. This is especially true when you're due diligence efforts will be judged after the fact, which always results in 20/20 vision.

Ultimately, the application of Section 10(b) liability related to a due diligence oversight for a broker-dealer is not supported by civil case law. While it may be viewed as another FINRA "tool" to fight fraud, the Justice Department, the SEC and the courts are the correct venues for enforcing Section 10(b) and Rule 10b-5 liability, not FINRA. Nevertheless, it is critical to listen to what we are being told by FINRA, because no one wants to be the next regulatory poster-child for a deemed oversight of due diligence with respect to private placements.

We believe that a review of the issues set forth in the Release, along with a determination as to whether your current due diligence process is reasonable, and addresses the critical points set out in the Release. To the extent weaknesses are found in your due diligence process and procedures they should be modified accordingly.

Should you have any additional questions or concerns, please feel free to contact Daniel E. LeGaye or Michael Schaps by e-mail or phone, at 281-367-2454, or consult with your legal counsel or third party consultant.