News Bulletin

May 2010

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

On April 20, 2010, the Financial Industry Regulatory Authority ("FINRA") issued Regulatory Notice 10-22 (the "Notice") reminding broker-dealers of their obligation – enforceable under federal securities laws and FINRA rules – to conduct a reasonable investigation of the issuer and the securities they recommend in offerings made pursuant to Regulation D under the Securities Act of 1933 (the "Securities Act").[1] The Notice also reinforces the obligations of broker-dealers that recommend securities offered under Regulation D to comply with the suitability requirements of NASD Rule 2310, the advertising and supervisory rules of FINRA and the rules and regulations of the Securities and Exchange Commission (the "SEC").

The following provides a summary of the Notice, including broker-dealers' regulatory responsibilities in Regulation D offerings, and the guidance set forth regarding broker-dealers' reasonable investigation and suitability obligations, and addresses FINRA's focus on enforcement.

Background and Overview of the Notice

The Notice results from FINRA's nationwide initiative to investigate broker-dealer activities in connection with private placements, an area where recent enforcement actions have uncovered a lack of regulatory compliance.[2] While the private placement market is an important source of capital for many U.S. companies, recent problems uncovered by FINRA in Regulation D offerings have resulted in sanctions on broker-dealer firms that provide private placement memoranda and sales materials to investors that contained inaccurate statements or omitted information necessary to make informed investment decisions. FINRA Chairman and CEO, Rick Ketchum, said that, "[a]n 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."[3]

Aimed at curtailing these regulatory compliance issues, the Notice reinforces and details broker-dealers' obligations in connection with Regulation D offerings. The Notice provides significant guidance to FINRA

[1] See FINRA Regulatory Notice 10-22 "Regulation D Offerings – Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings" (April 2010), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf.
[2] See FINRA news release announcing the Notice, available at http://www.finra.org/Newsroom/NewsReleases/2010/P121305.
[3] Id.

member firms regarding their duties to conduct reasonable investigations and customer suitability analyses in connecton with private placements to investors, including PIPEs, under Regulation D.

Broker-Dealers' Regulatory Responsibilities in Regulation D Offerings

Federal Antifraud Provisions and FINRA Rules – While Regulation D provides an exemption from the registration requirements under Section 5 of the Securities Act, Regulation D offerings are not exempt from the antifraud provisions, including Rule 10b-5, of applicable federal securities laws. The Notice details a broker-dealer's duty, when recommending a security, under case law and SEC interpretations, to conduct a reasonable investigation of both the securities offered and the issuer's representations about those securities. Specifically, FINRA reminds broker-dealers:

- The SEC and federal courts have long held that a broker-dealer that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer's representations about it.[4]
- This duty springs from the broker-dealer's special relationship to the customer, and from the fact that in recommending the security, the broker-dealer represents to the customer "that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation."[5]
- Courts have held that the scope of investigation required depends on the particular facts and circumstances. Relevant factors include the nature of the offering recommendation, the role of the broker-dealer in the offering, its knowledge of and relationship with the issuer, the size and stability of the issuer, and the level of sophistication of the investor (e.g., institutional, accredited or retail).[6]
- Failure to comply with this duty can constitute a violation of the antifraud provisions of the federal securities laws, including Rule10b-5.[7] It also can constitute a violation of FINRA Rule 2010, which requires broker-dealers to adhere to just and equitable principles of trade, and FINRA Rule 2020, which prohibits broker-dealers from engaging in manipulative and fraudulent behaviour.

Note that a broker-dealer also must comply with the advertising and supervisory rules of FINRA and the SEC.[8]

FINRA Suitability Obligations – A broker-dealer that recommends an issuer's securities in a Regulation D offering must also satisfy the "suitability requirements" under NASD Rule 2310. This rule requires that a broker-dealer have reasonable grounds to believe that a recommendation to purchase, sell or exchange a security is suitable for the customer.

There are two components to a broker-dealer's suitability obligation. *First*, the "reasonable basis suitability" component requires that the broker-dealer have a reasonable basis to believe, based on a reasonable investigation, that the recommendation is suitable for at least some investors. This requirement relates to the specific security recommended by a broker-dealer and imposes an obligation on the broker-dealer to investigate and obtain sufficient information about the security it is recommending. *Second*, the "customer specific suitability" component requires that the broker-dealer determine whether the security is suitable for the particular investor,

[4] See, e.g., *Hanly v. SEC*, 415 F.2d 589, at 595-96 (2d. Cir. 1969); see also Securities Act Release No. 4445, 27 Fed. Reg. 1415 (Feb. 2, 1962).
[5] See *Hanly*, supra note 4 at 597. FINRA has included a variation of this concept within its suitability rule, NASD Rule 2310, albeit without the scienter requirement of the federal antifraud provisions.
[6] See, e.g., *Hanly*, supra note 4.
[7] Particularly, Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. See generally *Hanly*, supra note 4.
[8] See NASD Rule 2210 (advertising rule), infra note 12. See also NASD Rule 3010 (supervisory rule) that requires broker-dealer firms participating in Regulation D offerings to have supervisory procedures that are reasonably designed to ensure that their personnel, including its registered representatives, conduct an investigation that is sufficiently thorough to comply with their legal and regulatory requirements.

based upon the investor's financial situation, needs and other security holdings.[9] This requirement is construed to impose a duty of inquiry on broker-dealers to obtain relevant investor information relating to their financial situation and to keep such information current.

The Notice provides guidance for broker-dealers to help ensure the fulfillment of their suitability responsibilities. Accordingly, in a Regulation D offering, a broker-dealer should, at a minimum, conduct a reasonable investigation concerning the:

- issuer and its management;
- business prospects of the issuer;
- assets held by or to be acquired by the issuer;
- representations and claims being made; and
- intended use of proceeds of the offering.

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

In the context of a Regulation D offering, NASD Rule 2310 requires broker-dealers to conduct a suitability analysis when recommending securities to both accredited and non- accredited investors. This analysis must take into account the investors' knowledge and experience. The fact that an investor meets the net worth or income test for being an accredited investor is only one factor involved in a complete suitability analysis. The broker-dealer must also make reasonable efforts to gather and analyze information about the customer's other security holdings, financial situation and needs, tax status, investment objectives, and any other information that would enable the broker-dealer to make its suitability determination. In addition, a broker-dealer must satisfy itself that the customer fully understands the risks involved and is able to take those risks.

What Level of Investigation is Required?

The short answer is that the level of investigation required depends upon the facts and circumstances in each case. While there are no clear-cut rules that set forth the scope of investigation required, the Notice provides some important guidance that broker-dealers should consider in making their determination:

- a broker-dealer should not rely, without some investigation, on information provided by the company or its advisors;
- the presence of "red flags" should alert the broker to the need for further inquiry;
- a more thorough investigation is required for smaller companies of recent origin;
- a broker-dealer that lacks essential information about an issuer or its securities when making a recommendation in a Regulation D offering must disclose this fact as well as the risks associated with the lack of information;
- the fact that a broker-dealer's customers may be sophisticated and knowledgeable does not obviate the duty to investigate; and

[9] See NASD Rule 2310(a). If a broker-dealer recommends a securities transaction to an "institutional investor," the broker-dealer will be deemed to have discharged its suitability obligation under NASD 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. See NASD Rule 2310(b) and NASD IM-2310-3.

- with respect to reporting companies under the Securities Exchange Act of 1934 (the "Securities Exchange Act"), in the absence of red flags, a broker-dealer that is not an underwriter typically may rely on the current registration statement and periodic reports of the public company.

Broker-dealers should retain records documenting both the process and results of their diligence investigation. A broker-dealer's reasonable investigation should be tailored to each Regulation D offering in a manner that best ensures that it meets its regulatory responsibilities. As a reference, FINRA provides a list of practices adopted by some broker-dealer firms to help them adequately discharge their responsibilities.[10] FINRA notes that the duty of inquiry under the antifraud provisions is distinguished from the "reasonable investigation" that, under Section 11(b) of the Securities Act, permits an underwriter to avoid liability for misrepresentations in a registration statement. FINRA further notes that courts have compared the Section 11 reasonable investigation requirements with the broker-dealer's general duty to investigate and concluded that somewhat more is required of an underwriter than a broker-dealer in order to discharge its obligation to the investing public.[11]

For the last two decades, we have been advising our investment banking clients of the importance of undertaking diligence exercises in private placements that are similar to what they might typically undertake in public offerings. Obviously, the depth and character of the diligence exercises will vary depending upon the facts specific to each issuer and each transaction. The Notice serves only to confirm this viewpoint.

The Notice also provides guidelines relating to specific issues that will help inform broker-dealers when making a determination of the scope of their investigation:

Broker-Dealer Affiliated with Issuer – A broker-dealer 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. A broker-dealer must also resolve any conflict of interest that could impair its ability to conduct a thorough and independent investigation.

Broker-Dealer Involved in the Preparation of the Private Placement Memorandum – A broker-dealer that prepares a private placement memorandum or other offering document has a duty to investigate securities offered under Regulation D and representations made by the issuer in the private placement memorandum or other offering document. Broker-dealers that are involved in the preparation of offering materials should be mindful of this heightened due diligence obligation, especially in light of FINRA's recent enforcement actions. The Notice also specifies that a broker-dealer that assists in the preparation of a private placement memorandum or other offering document should expect that it would be considered a communication with the public by that broker-dealer for purposes of NASD Rule 2210, FINRA's advertising rule.[12]

Red Flags – The Notice provides that a broker-dealer must note any information that it encounters in the course of a reasonable investigation that could be considered a "red flag" that would alert a prudent person to conduct further inquiry. The broker-dealer has a duty to follow up on any red flags by doing more than relying, without inquiry, on representations made by an issuer's management, disclosure in a memorandum or even a diligence report of issuer's counsel. Thus, the presence of red flags gives rise to a duty to conduct an independent investigation. Note that an issuer's refusal to provide a broker-dealer with information that is necessary for the broker-dealer to meet its duty to investigate may itself constitute a red flag.

---

[10] The list is set forth on page 8 – 10 of the Notice.
[11] See *University Hill Foundation v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 898 (S.D.N.Y. 1976) at 898-99. This is because "an underwriter's relationship to the issuer is more substantial" than a broker-dealer that is only recommending a security, and the underwriter "plays a more central role in the marketing process." Id.
[12] NASD Rule 2210 provides that all member communications with the public must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service, and that no member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading.

Reliance on Counsel and Syndicate Members – A broker-dealer may retain counsel or other experts to assist it in undertaking and fulfilling its reasonable investigation obligation. However, FINRA notes that this does not necessarily satisfy the broker-dealer's investigation responsibilities, insofar as such counsel's or expert's findings may identify issues or concerns that require further investigation by the broker-dealer. It is also common that a broker-dealer is a member of a syndicate or selling group. FINRA recognizes that the broker-dealer may 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 such an inquiry with respect to the particular Regulation D offering.

FINRA's Focus on Enforcement Actions

The Notice is an indication that FINRA intends to focus more actively on enforcement of its rules relating to Regulation D offerings against its members that are acting as placement agents. In recent months, FINRA has initiated three enforcement actions against broker-dealers. Market participants should expect this trend to continue. "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," said FINRA Chairman and CEO, Rick Ketchum.[13]

We would encourage broker-dealers to revisit their compliance procedures and practices relating to Regulation D offerings and to advise their personnel of any changes.

Contacts

Tim Cleary
(212) 336-4051
tcleary@mofo.com

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

James R. Tanenbaum
(212) 468-8163
jtanenbaum@mofo.com

Gerd D. Thomsen
(212) 336-4335
gthomsen@mofo.com

About Morrison & Foerster

We are Morrison & Foerster — a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, Fortune 100 companies, investment banks and technology and life science companies. Our clients count on us for innovative and business-minded solutions. Our commitment to serving client needs has resulted in enduring relationships and a record of high achievement. For the last six years, we've been included on *The American Lawyer*'s A-List. *Fortune* named us one of the "100 Best Companies to Work For." We are among the leaders in the profession for our longstanding commitment to pro bono work. Our lawyers share a commitment to achieving results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

[13] See FINRA news release announcing the Notice, supra note 2.