

ALERTS AND UPDATES

FINRA Issues Regulatory Guidance for Broker-Dealers' Investigations in Private Placements

April 28, 2010

The Financial Industry Regulatory Authority (FINRA) recently issued new [guidance](#)¹ for broker-dealers about their obligations regarding their due-diligence investigation of issuers and the securities they recommend in offerings made under the U.S. Securities and Exchange Commission's Regulation D under the Securities Act of 1933 – also known as private placements.

FINRA reinforces and details broker-dealers' obligation to conduct a reasonable investigation of the securities they recommend and the issuer's representations about them. "In general, FINRA notes that a broker-dealer 'may not rely blindly upon the issuer for information concerning a company,' nor may it rely on the information provided by the issuer and its counsel in lieu of conducting its own reasonable investigation." FINRA also emphasizes that dealing with a sophisticated and knowledgeable investor who is eligible to participate in a private placement does not obviate the broker-dealers' duty to investigate.

In addition to conducting a reasonable investigation of the issuer and its securities, a broker-dealer must: (i) have reasonable grounds to believe – based on a reasonable investigation – that its recommendation to purchase, sell or exchange a security is suitable for the particular customer to whom such recommendation is offered and (ii) ensure that the customer fully understands the risks involved in the investment. In order to ensure compliance with suitability responsibilities, FINRA states that a reasonable investigation by a broker-dealer should concern, at a minimum, the following:

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

Finally, FINRA highlights a broker-dealer's obligation to note, investigate and follow up on any "red flags" encountered during its inquiry. When encountering "red flags" or any substantial adverse information about the issuer during its investigation, a broker-dealer has the duty to conduct further independent investigation of the issuer's financial condition under the circumstances, in order to fulfill its due-diligence obligations.

This FINRA notice is consistent with the trend to find liability against all participants, including broker-dealers, in connection with the issuance of privately placed securities.

For Further Information

If you would like more information about this *Alert* or assistance in connection with due-diligence efforts, please contact any [member](#) of the [Corporate Practice Group](#) or the attorney in the firm with whom you are regularly in contact.

Note

1. Regulation D Offerings, FINRA Regulatory Notice 10-22 (April 2010).