FINRA Regulation of Broker-Dealer Due Diligence in Regulation D Offerings

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This Note discusses broker-dealers' affirmative obligation to conduct a reasonable investigation when recommending securities sold in offerings exempt from SEC registration under Regulation D of the Securities Act of 1933. The Note explains the FINRA rules and broker-dealer specific interpretations of the securities laws that impose this obligation. The Note also provides guidance on broker-dealer reasonable investigations in light of the Financial Industry Regulatory Authority's Regulatory Notice 10-22 and related enforcement actions.

The Financial Industry Regulatory Authority (FINRA) is the largest nongovernmental regulator for securities firms doing business in the US. FINRA oversees brokerage firms, branch offices and registered securities representatives, and regulates the conduct of its broker-dealer member firms. Section 15A of the Securities Exchange Act of 1934 (Exchange Act) gives FINRA the authority to discipline its member firms and certain individuals for violations of the securities laws and FINRA rules.

FINRA has brought disciplinary actions against broker-dealers and individuals employed by broker-dealers for either:

- Failing to conduct adequate due diligence before recommending securities sold in offerings exempt from SEC registration under Regulation D of the Securities Act of 1933 (Securities Act).
- Failing to implement adequate supervisory systems and procedures for due diligence in Regulation D offerings.

In April 2010, FINRA issued *FINRA Regulatory Notice 10-22* (*Regulation D Offerings: Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings*) (Notice 10-22). In Notice 10-22, FINRA notes that it had identified what it believes to be significant problems in broker-dealer due diligence investigations in Regulation D offerings. Notice 10-22 then reminds broker-dealers of their affirmative obligation under FINRA rules and long-standing interpretations of the securities laws to conduct a reasonable investigation before recommending securities offered under Regulation D to customers. FINRA's focus on Regulation D sharpened further in 2012, when it adopted FINRA Rule 5123, which requires broker-dealers to make notice filings when participating in certain private placements. For a further discussion of FINRA's rulemaking and enforcement focus on Regulation D offerings, see *Box, Private Placements: A Continuing FINRA Priority*.

In light of FINRA's focus on broker-dealer due diligence in Regulation D offerings, this Note:

- Explains which FINRA rules and securities laws create an obligation for broker-dealers to conduct a reasonable investigation before recommending securities sold in Regulation D offerings.
- Discusses FINRA guidance on what constitutes an adequate investigation in this context.
- Gives an overview of due diligence-related practices that FINRA has identified as inadequate in disciplinary actions relating to Regulation D offerings.

For more information on Regulation D offerings generally, see *Practice Notes, Section 4(a)(2) and Regulation D Private Placements (http://us.practicallaw.com/8-382-6259)* and *Road Map for Undertaking a Private Offering (http://us.practicallaw.com/4-501-6353)*.

AFFIRMATIVE OBLIGATION TO CONDUCT A REASONABLE INVESTIGATION

Regulation D provides two exemptions (Rules 504 and 505), and one safe harbor (Rule 506), from the registration requirements of Section 5 of the Securities Act. Offerings exempt from registration under Regulation D are **not** exempt from the antifraud provisions of the federal securities laws. A company seeking to raise capital in a Regulation D offering might engage a registered broker-dealer to assist it. For a further discussion of the role of registered broker-dealers and unregistered finders in Regulation D offerings, see *Practice Note, Road Map for Undertaking a Private Offering: Finding Investors (http://us.practicallaw.com/4-501-6353#a233437)*.

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For a further discussion of Regulation D generally, including recently adopted changes mandated by the JOBS Act, see *Practice Notes, Section 4(a)(2) and Regulation D Private Placements (http://us.practicallaw.com/8-382-6259)* and *JOBS Act: Regulation D and Rule 144A General Solicitation Summary (http://us.practicallaw.com/1-518-7172)*.

As most securities law practitioners are aware, a broker-dealer involved in an unregistered securities offering may conduct a due diligence investigation into the issuer and the offered securities for a variety of reasons, including:

- **Defense to antifraud liability for misstatements or material omissions.** To lay the groundwork for a defense to claims against the broker-dealer under the antifraud provisions of the securities laws, including Rule 10b-5 under the Exchange Act.
- **Reputational concerns.** To avoid participating in an offering where the broker-dealer's participation might tarnish its firm's reputation.

For a discussion of the purposes of due diligence in registered and unregistered securities offerings, see *Practice Notes, Due Diligence: Securities Offerings (http://us.practicallaw.com/4-380-7917)* and *Liability Provisions: Securities Offerings (http://us.practicallaw.com/6-381-1466)*.

As Notice 10-22 discusses, broker-dealers that recommend securities to customers, including in Regulation D offerings, also have a separate affirmative obligation to conduct a reasonable investigation of the issuer and the securities under both:

- The suitability requirement of FINRA Rule 2111 (see *Suitability Requirement*). Rule 2111 replaced its predecessor rule, NASD Rule 2310, in 2012.
- Broker-dealer specific interpretations of the antifraud provisions of the securities laws (see *Antifraud Provisions of the Securities Laws*).

SUITABILITY REQUIREMENT

A broker-dealer that recommends securities, including those offered under Regulation D, must meet the suitability requirement of Rule 2111. This means that the broker-dealer must have a reasonable basis to believe that a recommendation to purchase, sell or exchange a security is suitable for the customer.

To meet the suitability requirement, a broker-dealer's recommendation must satisfy three separate suitability obligations:

- **Customer-specific suitability.** The broker-dealer must have reasonable grounds to believe a recommendation is suitable for the particular customer.
- **Quantitative suitability.** The number of transactions the broker-dealer recommends to the customer in a certain period cannot be excessive. A discussion of customer-specific and quantitative suitability is beyond the scope of this Note.
- **Reasonable basis suitability.** The broker-dealer must have reasonable grounds to believe that a recommendation is suitable for at least some investors. This is known as reasonable basis suitability and is the source of a broker-dealer's obligation to perform a reasonable investigation of the issuer and offered securities before recommending securities in a Regulation D offering.

ANTIFRAUD PROVISIONS OF THE SECURITIES LAWS

The Securities and Exchange Commission (SEC) and federal courts have long held that a broker-dealer that recommends a security is under a duty to conduct a reasonable investigation into that 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. The duty arises from the interpretation of antifraud provisions known as "shingle theory."

Under shingle theory, in holding itself out to the public as a broker (or "hanging out a shingle"), a broker implicitly makes certain representations to customers. One of these implicit representations is that, when the broker recommends a security to a customer, the broker has determined that the security is suitable for that customer in light of the customer's financial situation and investment objectives (see *Hanly v. SEC, 415 F.2d 589, 596-97 (2d Cir. 1969)*). Therefore, the broker-dealer has a duty to conduct a reasonable investigation. A failure to comply with this duty can constitute a violation of the antifraud provisions of the federal securities laws, including Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 under the Exchange Act. It also can constitute a violation of FINRA Rule 2010, requiring adherence to just and equitable principles of trade, and FINRA Rule 2020, prohibiting manipulative and fraudulent devices.

As Notice 10-22 and case law on shingle theory discuss, the extent and nature of the investigation required to satisfy this obligation depends on, among other factors:

- The broker-dealer's role in the transaction.
- The broker-dealer's knowledge of and relationship to the issuer.
- The size and stability of the issuer.

Both the SEC and federal courts recognize that a more thorough investigation is required for securities issued by smaller, newly formed companies. Many Regulation D offerings are made by issuers fitting that description.

WHAT CONSTITUTES A REASONABLE INVESTIGATION?

There are no statutory provisions, rules or judicial decisions laying out exactly what type of inquiry satisfies a broker-dealer's obligation to conduct a reasonable investigation before recommending a security in a Regulation D offering. Notice 10-22 provides detailed guidance on:

- The minimum steps a reasonable investigation will include.
- Factors that broker-dealers should consider in determining the appropriate scope of an investigation in a particular offering.
- Practices that are consistent with an adequate due diligence investigation.

MINIMUM STEPS

According to Notice 10-22, to ensure that a broker-dealer has fulfilled its reasonable basis suitability responsibilities, the broker-dealer should, at a minimum, conduct a reasonable investigation concerning:

- The issuer and its management.
- The business prospects of the issuer.
- The assets held by or to be acquired by the issuer.

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- The claims being made in the private placement memorandum (PPM) or other offering document.
- The intended use of the proceeds of the offering.

Notice 10-22 clarifies that a broker-dealer must conduct a reasonable investigation for each Regulation D offering. The broker-dealer cannot rely on an investigation of an issuer it conducted in a previous offering.

FACTORS TO CONSIDER IN DETERMINING INVESTIGATION'S SCOPE

Notice 10-22 identifies factors that a broker-dealer should consider in determining the scope of its investigation in a particular Regulation D offering. These factors include:

- The broker-dealer's affiliation with the issuer (see *Affiliation with the Issuer*).
- Whether the broker-dealer prepared the PPM to be used in the offering (see *Preparation of the PPM*).
- The broker-dealer's lack of information (see *Lack of Information*).
- The presence of red flags (see *Red Flags*).
- Whether the broker-dealer is relying on counsel or a syndicate manager to conduct the diligence investigation (see *Reliance on Counsel or Syndicate Manager*).

Affiliation with the Issuer

A broker-dealer that is affiliated with the issuer must conduct an independent due diligence investigation. The broker-dealer must resolve any conflict of interest that could impair its ability to conduct a thorough and independent investigation. According to Notice 10-22, this is particularly important because a broker-dealer's customers might assume that an affiliated broker-dealer has even greater information than a nonaffiliated broker-dealer about an issuer due to its special relationship with the issuer.

Preparation of the PPM

Broker-dealers that prepare the PPM used in a Regulation D offering have a duty to investigate the representations made by the issuer in the PPM. Broker-dealers that have prepared PPMs have been held liable for material misstatements or omissions in those documents, and have been subject to FINRA enforcement actions, including under FINRA Rules 2010 and 2210 (FINRA Rule 2210 replaced NASD Rule 2210 effective February 4, 2013 (see *FINRA Regulatory Notice 12-29)*).

Since the publication of Notice 10-22, the US Supreme Court held in *Janus Capital Group, Inc. v. First Derivative Traders, 131 S. Ct. 2296 (June 13, 2011)* that only the "maker" of a statement, and not those who simply helped prepare and publish the statement, can be primarily liable for it under Rule 10b-5. Practitioners have suggested that, in light of Janus, Notice 10-22's suggestion that a broker-dealer who helps prepare a PPM should consider that PPM a communication by the broker-dealer should no longer be considered applicable. For a detailed discussion of Janus, see *Practice Note, Liability Provisions: Securities Offerings: Limitation of Liability Under Rule 10b-5 to Those Who Actually Make Misstatements (http://us.practicallaw.com/6-381-1466#a237699)*.

Lack of Information

During its investigation, if the broker-dealer discovers that it lacks essential information about an issuer or its securities, the broker-dealer must disclose this fact, and the risks that arise from its lack of information, to its customers if and when it recommends the security in spite of its lack of information.

Red Flags

During its investigation, a broker-dealer must follow up on any information that:

- Could be considered a "red flag," which Notice 10-22 explains means, in this context, information that would alert a prudent person to conduct a further inquiry.
- Is substantial adverse information about the issuer.

When presented with red flags, the broker-dealer must do more than rely on representations by the issuer's management, the disclosure in the PPM, a due diligence report of the issuer's counsel or even the audit report of the issuer's auditor. An issuer's refusal to provide a broker-dealer with information requested in the investigation process can constitute a red flag. Where an issuer is non-responsive to requests for information, the broker-dealer must determine whether sufficient information is otherwise available. Lastly, Notice 10-22 notes that the fact an issuer is not planning to prepare a PPM for an offering can be a red flag. Even though PPMs are not required in certain Regulation D offerings, it is market practice to prepare them in most offerings. A departure from this market practice may raise questions the broker-dealer should follow up on.

Reliance on Counsel or Syndicate Manager

If a broker-dealer chooses to retain or rely on counsel or other experts to assist it in fulfilling its reasonable investigation obligation, it must carefully review the qualifications and competency of the counsel or experts. The broker-dealer must ensure that any gaps or omissions in the counsel's or expert's investigation are separately addressed by the broker-dealer.

When a broker-dealer is a member of a selling group (and not itself a syndicate manager), it may be appropriate for the broker-dealer to rely on the reasonable investigation of the syndicate manager. However, if the broker-dealer plans to do this, it should meet with the manager and obtain a description of the manager's reasonable investigation efforts. The broker-dealer should ask the manager questions about the manager's independence, and about the thoroughness of its investigation. The broker-dealer remains responsible for ensuring that the syndicate manager's investigation covered all key issues, including all issues that factor into the broker-dealer's suitability analysis.

Investigation Required Even When Customers are Sophisticated

Notice 10-22 notes that a broker-dealer has an obligation to perform a reasonable investigation even when it recommends securities to sophisticated or knowledgeable customers. However, the Notice notes that the **scope** of a broker-dealer's investigation can take into account whether the customers involved are retail customers or more sophisticated institutional investors.

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RELIANCE ON THE ISSUER AND ITS SEC FILINGS

Under Notice 10-22, a broker-dealer cannot satisfy its obligation to conduct a reasonable investigation by relying on the issuer. In addition, a broker-dealer cannot rely on the information provided by the issuer and its counsel instead of conducting its own investigation. Rather, broker-dealers must exercise a high degree of care in investigating and independently verifying an issuer's representations and claims. However, Notice 10-22 notes that, when the issuer in a Regulation D offering is an SEC reporting company, in the absence of red flags, a broker-dealer that is not acting as an underwriter typically can rely on the issuer's current registration statement and periodic reports as part of its investigation process.

POLICIES AND PRACTICES FOR COMPLIANCE

Notice 10-22 contains specific guidance on policies and practices that are required of, or recommended as a best practice for, broker-dealers participating in Regulation D offerings.

ESTABLISHING SUPERVISORY PROCEDURES

Notice 10-22 reminds broker-dealers that the requirement that a broker-dealer establish supervisory procedures for the broker-dealer's activities applies to its participation in Regulation D offerings. Therefore, broker-dealers that participate in Regulation D offerings must have supervisory procedures in place to ensure personnel:

- Conduct a reasonable investigation before recommending to customers securities offered under Regulation D.
- Perform the required suitability analysis (see *Suitability Requirement*).
- Sell securities only to appropriate customers. For information on the purchaser requirements of Regulation D, see *Practice Note, Section 4(a)(2) and Regulation D Private Placements: Regulation D Safe Harbor Requirements (http://us.practicallaw.com/8-382-6259#a73659)*.
- Do not violate the antifraud provisions of the securities laws or FINRA rules when they prepare or distribute a PPM or other offering document.

DOCUMENTING THE INVESTIGATION

Notice 10-22 suggests that throughout the investigation process, a broker-dealer should retain records documenting both the process and the results of its investigation. This can help the broker-dealer demonstrate that it has performed a reasonable investigation. These records might include:

- Descriptions of meetings held, including the date and list of attendees.
- Documents reviewed, the reviewer and the results of the review.

INVESTIGATION PRACTICES CHECKLIST

While a broker-dealer's reasonable investigation must be tailored to each Regulation D offering, Notice 10-22 identifies a checklist of industry practices that, if performed, will help ensure that a broker-dealer has met its reasonable investigation obligations. These practices include:

- **Investigating the issuer and its management by:**
  - examining the issuer's governing documents (for example, its charter, bylaws or partnership agreement);
  - inquiring about the business of the issuer's affiliates and their financial reliance on issuer;
  - examining the issuer's historical financial statements;
  - inquiring about the issuer's internal audit controls;
  - reviewing the issuer's contracts, leases, financing arrangements and other similar documents;
  - inquiring about the issuer's past securities offerings;
  - inquiring about pending litigation;
  - inquiring about previous or potential regulatory or disciplinary problems the issuer has faced;
  - making inquiries concerning the issuer's management, including asking about their expertise and disciplinary history;
  - inquiring about forms and amount of management compensation; and
  - inquiring about how long the issuer has been in business and whether the focus of the issuer's business is expected to change.
- **Investigating the issuer's business prospects by:**
  - inquiring about the viability of patents or other intellectual property;
  - inquiring about the issuer's industry, including industry prospects, applicable regulation and competition;
  - reviewing the issuer's business plans; and
  - reviewing the issuer's financial models and targets.
- **Investigating the issuer's assets by:**
  - visiting the issuer's facilities;
  - inspecting samples of issuer's assets;
  - examining third-party reports, for example, geological, land use and engineering reports, as relevant to the particular issuer; and
  - obtaining expert opinions, especially when the issuer is in the energy and exploration business.

FINRA DISCIPLINARY ACTIONS

Broker-dealers and associated persons that have been the subject of FINRA disciplinary actions for failing to meet their reasonable investigation obligation in Regulation D offerings have generally performed cursory due diligence investigations. Many have relied on reviewing only the PPM or other offering documents. Disciplinary actions have identified the following problems with due diligence investigations:

- The diligence review consisted only of the broker-dealer reviewing the issuer's unverified and uncorroborated statements in the PPM or other offering document.
- The broker-dealer did not obtain or review the issuer's financial statements.
- The broker-dealer did not visit the issuer's facilities or meet with its key personnel.

- The broker-dealer failed to research background information on the issuer's officers.
- The broker-dealer did not use the services of third-party due diligence providers.
- The broker-dealer failed to follow up on "red flags," including red flags revealed in third-party due diligence reports.
- The broker-dealer did not have internal policies outlining the steps required in a due diligence investigation, or specifying who was responsible for carrying out those steps.
- The broker-dealer's due diligence procedures were inadequate, including because the procedures were too vague or delegated too much responsibility to one employee without specifying any oversight.
- An associated person failed to follow the broker-dealer's due diligence procedures.

In one such action, a broker-dealer and its president (who was identified in the firm's internal procedures manual as responsible for overseeing private placements) settled allegations brought by FINRA that the broker-dealer violated FINRA due diligence and supervisory rules in three Regulation D offerings. The firm was ordered to pay restitution to its customers, and its president was fined $10,000 and barred from associating with any FINRA member broker-dealer in any principal capacity (*Workman Securities Corporation*, *FINRA AWC No. 20090188184*, *February 1, 2011*).

The due diligence investigations in these offerings, which were conducted by the president, consisted of:

- Reviewing the PPMs.
- Reading due diligence reports prepared by third parties.
- Discussing the securities with other broker-dealers that had participated in earlier offerings by the same issuer.
- Discussing the current offering with colleagues at the firm who had visited the issuer's facilities and participated in earlier offerings by the issuer while they worked for other firms.

FINRA found these due diligence investigations inadequate for the following reasons:

- The broker-dealer did not investigate multiple red flags, including information that one issuer had liquidity concerns, had missed interest payments and had defaulted on obligations. The broker-dealer was aware of these facts because they were mentioned in a third-party diligence report it reviewed, and in other sources.
- Third-party due diligence reports the broker-dealer relied on as part of its diligence were prepared months after the broker-dealer had begun selling securities in the offerings.
- The president did not personally visit issuer headquarters to conduct due diligence.
- The president did not take adequate steps to ensure that the firm representatives who visited issuer facilities were qualified to conduct thorough due diligence.
- The president did not take appropriate steps to supervise the purported due diligence being conducted by the firm's representatives.
- The president did not verify, through third-party sources other than the third-party due diligence reports, issuer representations and information.
- The president did not verify what due diligence, if any, had been conducted by the four other broker-dealers that he spoke with that had sold prior offerings of one of the issuers. Nor did he seek or obtain due diligence documentation obtained by these other broker-dealers.
- The president's review of the PPM was only cursory. He reviewed the document only to ensure that the offering was similar to the issuer's previous offerings.

In another action settled by a broker-dealer, FINRA found inadequate a broker-dealer's due diligence investigation performed for private placements by two related investment funds that themselves invested in mortgage loans. The firm was ordered to pay a $200,000 fine and restitution to its customers. This finding was based on the following:

- The broker-dealer continued selling the funds' securities in private placements without conducting any enhanced due diligence after becoming aware of several red flags, including:
  - a third-party diligence report about one fund revealing that the default rate for the fund's loan portfolio was approximately 20%;
  - information that one fund was experiencing financial difficulties; and
  - information that a due diligence report was being prepared on one fund (the broker-dealer did not wait for the report to be completed before approving sale of the fund's securities).
- The broker-dealer delegated nearly all responsibilities for private placements, including conducting due diligence, to one employee and had no procedures in place to assess if that employee was adequately performing his responsibilities.
- For much of the relevant period, the broker-dealer lacked written supervisory procedures for private placements. When it adopted them, the procedures were not sufficiently detailed or tailored for the private placement context.

(*Sunset Financial Services, Inc., FINRA AWC No. 2011026915701, July 17, 2013*).

In an action settled by an associated person of a broker-dealer, FINRA found that a due diligence investigation performed for an ongoing private placement of fund securities was inadequate because, among other reasons, the associated person did not follow the broker-dealer's written supervisory procedures for private placement due diligence. For example, the associated person did not review the issuer's financial statements, visit the issuer's office, review the background of the issuer's management or the issuer's formation documents, or attempt to determine if the projected internal rates of return contained in the offering document were viable. The associated person was suspended for one year in any principal capacity and ordered to pay a $5,000 fine (*In the Matter of Gary Mitchell Spitz, Respondent (FINRA AWC No. 2012030787301, May 14, 2013*).

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PRIVATE PLACEMENTS: A CONTINUING FINRA PRIORITY

FINRA has highlighted private placements as an area of concern in its past six annual Regulatory and Examination Priorities Letters.

In its 2015 Regulatory and Examination Priorities Letter, FINRA indicated that it will continue to focus on private placements in 2015. The letter highlights that FINRA reviews broker-dealers' filings under FINRA Rule 5123 to determine whether firms have performed sufficient due diligence before making recommendations to customers. FINRA's reviews have revealed that, in some cases, the level of firms' due diligence:

- Did not comply with the broker-dealer's procedures.
- Appeared to be inadequate to support a suitability determination.

The letter also notes that, as part of its review of private placement filings, FINRA staff have identified:

- Offering documents and communications containing misrepresentations, material omissions and inconsistencies with FINRA's communication rules.
- Problems concerning compliance with Rules 10b-9 and 15c2-4(b) under the Exchange Act in contingency offerings, including:
  - the absence of, or deficient, escrow procedures; and
  - failures to properly conduct recission offers following offering amendments.

The letter also notes that both the SEC and FINRA have reminded investors to be prudent when evaluating the risks posed by investments offered in private placements marketed using general solicitation in reliance on Rule 506(c) under the Securities Act. For a further discussion of the 2015 letter, see *Legal Update, FINRA Publishes 2015 Regulatory and Examination Priorities (http://us.practicallaw.com/1-594-7605)*.

FINRA's annual letters for 2010, 2011, 2012, 2013 and 2014 also identified private placements as an area of FINRA focus. The 2013 letter stated in particular that the relative scarcity of independent financial information and the uncertainty surrounding the market- and credit-risk exposures associated with many private placements makes reasonable due diligence on prospective issuers necessary. It also suggests that this due diligence should focus on:

- The issuer's creditworthiness.
- The validity and integrity of its business model.
- The plausibility of expected rates of return compared to industry benchmarks.

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