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FINRA Guidance: Member Firms' Responsibilities in Regulation D Offerings

In April 2010, FINRA published Regulatory Notice 10-22 providing guidance to member firms with respect to their obligations in conducting Regulation D offerings. In particular, FINRA asserts that a member firm has a duty to conduct a reasonable investigation of the issuer for any Regulation D offering recommended to customers.[1]

I. Duty to Conduct a Reasonable Investigation

When recommending a security, a FINRA member firm is under a duty to have reasonable grounds to believe that the recommended investment is suitable for investors generally, and that the investment is suitable to the investor to whom it is being recommended.[2] It is FINRA's recently-published position that, when discharging this duty in connection with an offering being privately placed in accordance with Regulation D, the FINRA member must conduct a reasonable investigation concerning that security and the issuer's representations about it. FINRA reasons that a firm's recommendation of a security contains an implied representation that the firm has conducted a reasonable investigation.

Failure to conduct a reasonable investigation, FINRA states, can constitute a violation of the antifraud provisions of the federal securities laws[3] as well as FINRA Rule 2010, requiring adherence to just and equitable principles of trade, and FINRA Rule 2020, prohibiting manipulative and fraudulent practices.

A. Guidelines for Required Investigation

FINRA notes that the amount and nature of the required investigation by the broker-dealer depends upon, among other factors, the nature of the firm's recommendation, the role of the firm in the transaction, the firm's knowledge of and relationship to the issuer, and the size and stability of the issuer. Particular care is required for offerings related to new, speculative ventures.

FINRA asserts that a reasonable investigation will encompass, at a minimum:

- Issuer and management;
- Business prospects of issuer;

[1] The Notice is available at http://www.finra.org/Industry/Regulation/Notices/2010/P121299.

[2] *See* NASD Rule 2310, "Recommendations to Customers (Suitability)."

[3] While the Notice states generally that "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…", we do not understand the duties of broker-dealers acting in various specific contexts to be as clearly – or as cleanly – settled as the Notice suggests. Assuming that the duties created by federal law are more complex, and in some cases narrower, than those posited by the Notice, the statements by FINRA throughout the Notice raise the interesting issue of whether and under what circumstances the terms of the Notice will now become the enforceable policy of FINRA even when there is no violation of federal law.

- Assets held by or acquired by issuer;
- Claims being made; and
- Intended use of proceeds.[4]

FINRA also addresses the question of whether or not a member firm may rely on information supplied by the issuer in making its recommendation, noting that the permissibility of such reliance will depend upon the facts and circumstances of the offering.[6] Further, FINRA asserts that even if the firm's customers are sophisticated and knowledgeable, there is still a duty to investigate.

According to the Notice, member firms are permitted to rely on investigations of counsel or syndicate managers, but the firm must review the qualifications of outside experts and must address gaps or omissions in their investigations. FINRA asserts that any firm that intends to rely upon the efforts of a syndicate manager should meet with the manager, obtain a description of the manager's investigation efforts, and ask questions of the manager concerning the independence and thoroughness of the manager's exercise of its responsibilities.

Further, FINRA also emphasizes that the duty to conduct an investigation applies to each Regulation D offering. Therefore, even though member firms may be able to rely on information obtained in previous investigations of the issuer, such prior investigations do not relieve firms of their duty with respect to the current offering.

B. Supervisory Procedures Regarding Investigations

A member firm participating in Regulation D offerings must have supervisory procedures that are reasonably designed to ensure that its personnel:

- Engage in an inquiry that is sufficiently rigorous to comply with their legal and regulatory requirements;
- Perform the suitability analysis required by NASD Rule 2310;
- Take steps to ensure that their customers are qualified as eligible to purchase securities offered pursuant to Regulation D; and
- Do not violate the antifraud provisions of the federal securities laws or FINRA rules in connection with their preparation or distribution of offering documents or sales literature.

C. Documentation

The Notice reminds member firms that they should retain records documenting both the process and results of the investigation. Such records may include:

- Descriptions of the meetings that were conducted in the course of the investigation, including meetings with the issuer or other parties;
- Tasks performed;
- Documents and other information reviewed;
- Results of such reviews;
- Dates such events occurred; and
- Individuals who attended the meetings or conducted the reviews.

D. Broker-Dealer-Prepared PPMs as Communications with the Public

FINRA-member firms should be aware that, under the Notice, FINRA takes the view that when a member firm "assists in the preparation" of a private placement memorandum ("PPM"), the PPM will be considered a communication with the public by that broker-dealer for purposes of NASD Rule 2210, FINRA's advertising rule. That rule may, depending on the circumstances, require the filing and review of such materials with and by FINRA. If a PPM presents information that is not fair

[4] Additional FINRA guidance regarding reasonable investigation practices can be found at pages 8 through 10 of the Notice, available at http://www.finra.org/Industry/Regulation/Notices/2010/P121299

[6] With respect to reporting companies, in the absence of red flags the firm may typically rely upon the current registration statement and periodic reports of the company.

and balanced or that is misleading, then the firm that assisted in its preparation may be deemed to have violated NASD Rule 2210.

II. Suitability Obligations for Regulation D Offerings

Under NASD Rule 2310, a firm must have reasonable grounds to believe that a recommended transaction is suitable for the customer. FINRA reminds firms that the accredited investor status of offerees in a Regulation D transaction does not relieve the firm of the need for a suitability determination. The firm must make reasonable efforts to gather and analyze information about an investor's goals and sophistication and must be satisfied that the customer understands the risks of the investment and is prepared to take those risks.

The Notice asserts that a reasonable investigation, as described above, is also relevant to the fulfillment of member firms' suitability obligations.

III. Conclusion

The Notice may signal that FINRA will take a more aggressive enforcement stance with respect to member firms' participation in Regulation D offerings, including PIPES. Member firms would therefore be well-advised to review their compliance procedures in light of FINRA's new guidance.

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