

June 11, 2010

Due Diligence in Regulation D Offerings

FINRA Provides Guidance on the Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings

SUMMARY

FINRA has published a regulatory notice providing guidance to broker-dealers concerning their obligation to conduct a reasonable investigation of the issuer and the offered securities in offerings made under the SEC's Regulation D, which exempts certain limited offerings from the registration requirements of the Securities Act of 1933. FINRA cites two sources for this obligation. The first is the broker-dealer's special relationship to the customer and the fact that in recommending the security (which it is deemed to do when it offers the security to a customer in the placement), 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. According to FINRA, 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, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. The second source is NASD Rule 2310, which imposes on broker-dealers the obligation to make a "reasonable basis" suitability determination.

The notice discusses the following specific issues related to a broker-dealer's responsibilities:

- Resolving conflicts of interest in the investigation process when the broker-dealer is an affiliate of the issuer.
- The special responsibility of the broker-dealer that prepares the private placement memorandum ("PPM").
- Heightened duties of inquiry in the presence of red flags arising in the review process.
- Reliance on counsel and other experts.

FINRA also addresses supervisory procedures and documentation of reasonable investigation. Finally, FINRA provides a suggested list of items to examine in the private placement review process.

BACKGROUND

FINRA's guidance on Regulation D offerings was issued on April 15, 2010 as FINRA Regulatory Notice 10-22 (FRN 10-22).¹ This is one of a series of notices FINRA (and its predecessor, the NASD) has issued providing guidance to broker-dealers concerning the sale of special investment products.² FINRA has also taken a special interest in situations where FINRA member firms participate in private placements of interests in the member itself or certain affiliates. This interest resulted in the adoption of Rule 5122, applicable to member private offerings, in June 2009.

SOURCES OF THE BROKER-DEALER'S DUTY TO INVESTIGATE

Antifraud Provisions. FINRA asserts that a broker-dealer's duty to conduct a reasonable investigation emanates from its 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." The quoted language is taken from *Hanly v. SEC*.³ FINRA goes on to say, again citing *Hanly*, that "[f]ailure to comply with this duty can constitute 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 thereunder."⁴

FINRA also makes reference to its own antifraud rules, stating that failure to comply with the duty to investigate 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.⁵

Based on its reading of the antifraud provisions of the securities laws and FINRA rules, FINRA concludes that a broker-dealer has a duty to conduct an independent investigation of the issuer and the offering.

¹ Available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf>

² See, e.g., NTM 03-07 (Hedge Fund Interests); NTM 05-59 (Structured Products); FRN 09-73 (Principal Protected Notes); FRN 10-09 (Reverse Convertible Products).

³ 415 F.2d 589, 597 (2d Cir. 1969) at n.5.

⁴ The liability, under Sections 17(a) and 10(b) and Rule 10b-5, of a broker-dealer selling securities pursuant to an offering document without conducting an investigation, has not been firmly established as a matter of law. In the recent case of *SEC v. Tambone*, 597 F.2d 436 (1st Cir. 2010), the First Circuit Court of Appeals, deciding *en banc*, held that a securities professional who uses an offering document prepared by another person does not thereby "make" the statements in the offering document, for purposes of determining whether the person has made an untrue statement of a material fact within the meaning of Rule 10b-5. Thus, according to the Court, Rule 10b-5 would not impose liability on a broker-dealer that sold securities by means of an offering document that contained untrue statements of material fact if the broker-dealer did not participate in the preparation of the document, whether or not the broker-dealer conducted an investigation of the facts contained in the offering document.

⁵ Formerly NASD Rules 2110 and 2120.

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The amount and nature of the investigation depends, among other factors, on the nature of the broker-dealer's recommendation, its role in the transaction, its knowledge of and relationship to the issuer, and the size and stability of the issuer. For example, a more thorough investigation is required for securities issued by smaller companies of recent origin. The broker-dealer must also look for the presence of so-called red flags to determine whether further inquiry is necessary.

FINRA states that a broker-dealer may not blindly rely upon the issuer and its counsel for information in lieu of conducting its own investigation. If the broker-dealer lacks essential information about the issuer or its securities when it makes an investigation, it must disclose that fact to its customer, as well as the risks that arise from the lack of information.

FINRA notes that the fact that the broker-dealer's customers may be sophisticated and knowledgeable does not obviate its duty to investigate.

Suitability Obligations. The second source of the broker-dealer's duty to investigate is NASD Rule 2310, which states that a broker-dealer must have reasonable grounds to believe that a recommendation to purchase, sell or exchange securities is suitable for the customer. The suitability analysis has two components: "reasonable basis suitability" and "customer-specific suitability."

The reasonable basis suitability analysis requires the broker-dealer to have a basis to believe, based on a reasonable investigation, that the recommendation is suitable for at least some investors. The customer-specific suitability analysis requires that the broker-dealer determine whether the security is suitable for the customer to whom it would be recommended. FINRA points out that the fact that an investor meets the net worth or income test to be an accredited investor is only one factor to be considered, along with the other factors identified in Rule 2310, including the customer's investment objectives, other holdings, financial situation and tax status. Furthermore, the broker-dealer must be satisfied that the customer fully understands the risks involved and is able to take those risks.⁶

FINRA's guidance states that in order to ensure that it has fulfilled its suitability obligations, a broker-dealer in a Regulation D offering 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;
- The claims being made; and
- The intended use of proceeds of the offering.

⁶ FINRA cites *James B. Chase*, 56 S.E.C. 149, 159 (2003).

RESPONSIBILITIES IN SPECIAL SITUATIONS

FINRA's guidance discusses the broker-dealer's responsibilities in four special situations.

1. **Affiliation with Issuer.** A broker-dealer that is affiliated with the issuer in a private placement must ensure that its affiliation does not compromise its independence in conducting an investigation. FINRA states that the broker-dealer's affiliation with the issuer typically would raise expectations among customers that the broker-dealer has special expertise concerning the issuer.
2. **Broker-Dealer that Prepares the PPM.** FINRA points out that participation in preparing a PPM imposes additional responsibilities on a broker-dealer. In a recent enforcement action, FINRA found that a broker-dealer that prepared a PPM containing material misstatements and omissions about such matters as the amount and timing of distributions and the targeted return of principal to investors violated FINRA Rule 2010, which requires broker-dealers to comply with just and equitable principles of trade.⁷ A PPM prepared in whole or in part by a broker-dealer is considered a communication with the public for purposes of NASD Rule 2210, the FINRA advertising rule, which would subject the PPM to the content, supervision and record-keeping requirements of that rule.
3. **Red Flags.** FINRA advises that a broker-dealer must note any red flags – information it encounters in the course of its investigation that would alert a prudent person to conduct further inquiry. For example, while it is reasonable in ordinary circumstances to rely on the accuracy of financial statements that are audited and certified by an accountant, if a broker-dealer discovers information indicating that the financial statements are inaccurate, it must make a further investigation into the financial information. FINRA also notes that an issuer's refusal to provide a broker-dealer with information necessary for the broker-dealer to do its investigation should itself be considered a red flag. Similarly, the decision not to provide a PPM in an offering to accredited investors, although permitted by Regulation D, may be considered a red flag in some cases.
4. **Reliance on Counsel and Syndicate Managers.** FINRA acknowledges that broker-dealers may use counsel and other experts to assist it in fulfilling its reasonable investigation obligations. However, the broker-dealer must take the following steps among others to make sure its responsibility is properly discharged:
 - Review the qualifications and competency of the counsel and experts used;
 - Ensure that any gaps or omissions by counsel or experts are addressed; and
 - Review the results of the investigation by counsel or experts for red flags or other factors requiring further inquiry.

⁷ *Pacific Cornerstone Capital, Inc.*, FINRA AWC No. 2007010591701 (2009).

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A broker-dealer participating in a syndicate or selling group may rely on a reasonable investigation by the syndicate manager if the broker-dealer has reason to believe the syndicate manager has the necessary expertise and absence of conflicts to engage in a thorough and independent inquiry, and that it has performed the inquiry. FINRA states that any broker-dealer that intends to rely on the efforts of a syndicate manager should meet with the manager, obtain a description of the manager's reasonable investigation efforts, and ask questions of the manager concerning the independence and thoroughness of the manager's exercise of its responsibilities. The broker-dealer retains the responsibility to address gaps in the syndicate manager's investigation, for example, issues that may be relevant to the suitability determinations for the broker-dealer's own customers.

SUPERVISION AND DOCUMENTATION

FINRA advises that a firm that engages in Regulation D offerings must have supervisory procedures under NASD Rule 3010 that are reasonably designed to ensure that the firm's personnel:

- Engage in an inquiry that is sufficiently rigorous to comply with the firm's legal and regulatory requirements;
- Perform the suitability analysis under NASD Rule 2310;
- Qualify customers as eligible to purchase securities offered pursuant to Regulation D; and
- Do not violate antifraud provisions in the preparation or distribution of offering documents or sales literature.

In order to demonstrate that it has performed a reasonable investigation, a broker-dealer should retain records documenting the process and results of its investigation. Those records may include descriptions of the meetings that were conducted in the course of the investigation, including meetings with the issuer or other parties, the tasks performed, the documents and other information reviewed, the results of such reviews, the date such events occurred, and the individuals who attended the meetings or conducted the reviews.⁸

REASONABLE INVESTIGATION PRACTICES

Although FINRA says that no single checklist of investigation practices will suffice for every offering, and that mechanical reliance on checklists may result in inadequate investigations, FINRA provides a list of 21 items for investigation in three categories: issuers and management, issuer's business prospects and issuer's assets. The items were suggested by industry participants surveyed by FINRA. Items relating to the issuer and management include:

⁸ While FINRA does not make this point in its guidance, broker-dealers that engage in Regulation D offerings should expect that in routine FINRA examinations, FINRA may ask for copies of supervisory procedures covering Regulation D due diligence investigations and records of investigations made in recent offerings.

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- Looking for trends indicated by the financial statements;
- Inquiring about internal audit controls; and
- Making reasonable inquiries about the issuer's management, and about the forms and amount of management compensation.

Items relating to the issuer's business prospects include:

- Inquiring about the viability of any patent or other intellectual property rights held by the issuer; and
- Requesting financial models used to generate projections or targeted returns.

Items relating to the issuer's assets include:

- Visiting and inspecting a sample of the issuer's assets and facilities;
- Carefully examining any geological, land use, engineering or other reports by third-party experts that may raise red flags; and
- Obtaining, with respect to energy development and exploration programs, expert opinions from engineers, geologists and others.

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